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CONTROLS ON THE EXPORT OF CAPITAL FROM THE UNITED STATES

HEARINGS

BEFORE THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

S. 812

TO AMEND THE EXPORT ADMINISTRATION ACT OF 1979 TO AUTHORIZE CONTROLS ON THE EXPORT OF CAPITAL FROM THE UNITED STATES

SEPTEMBER 26 AND DECEMBER 4, 1985

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CONTROLS ON THE EXPORT OF CAPITAL FROM THE UNITED STATES

THURSDAY, SEPTEMBER 26, 1985

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Dodd, and Dixon.

OPENING STATEMENT OF CHAIRMAN GARN

The **Chairman**. The Banking Committee will come to order.

This morning the committee begins legislative hearings on S. 812, the Financial Export Control Act.

Senator Proxmire and I introduced this legislation this spring in order to draw attention to the renewed lending by American commercial banks to the Soviet bloc countries and to initiate a discussion of the consequences of such lending.

Already this year, United States banks have shepherded a reported $1.3 billion to these countries, including $200 million to the Soviet Union.

The bill that we have introduced is a modest one. It gives the President authority to control loans to the Soviet bloc but it does not require the President to exercise that authority. Under existing law, the President can control international loans in the case of a declared economic emergency.

When Senator Proxmire and I introduced the legislation, one loan, for $500 million, had been made to East Germany. Since then, however, the pace has accelerated. Citibank helped to syndicate a reported $600 million loan to East Germany. First Chicago syndicated a $200 million loan to the Soviet Union.

It is becoming apparent to me that serious consideration must now be given to granting the President authority to control such loans and to do so before we find ourselves in another Polish debt crisis or an East German debt crisis.

Just last week, the administration released a report that should cause worry for all of us entitled: "Soviet Acquisition of Militarily Significant Western Technology: An Update." The report outlines in shocking detail the benefits that the Soviets have gained militarily from Western technology. The report concludes that virtually every Soviet military research project, well over 4,000 each year in the late 1970's and over 5,000 in the early 1980's, benefits from these technical documents and hardware.

The assimilation of Western technology is so broad the United States and other Western nations are thus subsidizing the Soviet military buildup. The report goes further and discusses the financial investment the Soviets make to acquire our technology, more than $1.5 billion each year. The Soviets spent $140,000 for documents on the control system of the space shuttle, another $140,000 for high-energy laser technology, $560,000 were allocated for selected research documents on the ABM technology.

That money goes to people like the John Walker family, or the smugglers of computers, lasers, and communications equipment.

Where does it come from? John Walker wasn't paid in rubles. He was paid in United States dollars which the Soviets had to get somehow. The Soviets have been notoriously unable to produce products of sufficient quality to export, forcing them to rely on exports of natural gas and other natural resources, and weapons. With gold and energy prices way down and most recipients of Soviet weapons unable to pay in hard currencies, the Soviets find themselves in a bind while their high-technology appetite is on the increase.

Then we have this loan of $200 million to the Soviet Union. What are they going to use that money for? The stated purpose, according to the testimony of Mr. McDonough of First Chicago, who we'll hear from later today, is to fund imports from the home countries of the participating banks. That seems very clear to me, and we have this detailed report from 22 U.S. Government agencies describing what kind of imports.

When we're dealing with the Soviet Union and its allies, countries against which we maintain export controls on high technology because of the danger of such exports to our own national security, I have great trouble considering multimillion-dollar loans purely a private matter. When we're dealing with an economy totally under the control and management of that type of government, I find it difficult to accept arguments that we should deny our Government authority to manage our economic relations with that country, should the national interests require it.

Typically, bankers will explain that their policies are apolitical, but their actions have undeniable political consequences. Moreover, such protests have a hollow ring to me in light of the very public loan policies of these same banks toward South Africa. I have no problem condemning apartheid, but I find it very difficult to say that the oppression in Eastern Europe and the Soviet Union is more acceptable. In terms of national security, it's the Soviet Union whose missiles are targeted at the United States and Western European cities.

I could perhaps go on at great length discussing the terms of these loans to the Soviets. I don't think that there is anyone in any of these banks who would feel comfortable explaining to a farmer in this country or to a young family trying to buy their first home the generous loan terms given the Soviets. How do you explain to that farmer or that young person a rate of 9 percent to the Soviet Union, which would be the approximate rate today for payment of the recent $200 million loan.

Today we will look at these questions and we'll discuss whether the President should have this authority. This is a bipartisan issue. Senator Proxmire and I worked very closely in our recent efforts to improve the Export Administration Act, and I appreciate his support on this important issue.

As a matter of fact, the things I've talked about in my opening statement today are not new to either Senator Proxmire or me. Both of us have been talking about them for a long, long time. He, a long time ago, more than 6 years ago, when he was chairman of this committee, and both of us have worked on it for years. To put it very bluntly, we are tired of subsidizing the Soviet Union. We are tired of double standards. Neither one of us agrees with South Africa's policies, but we hardly agree with what's going on in Afghanistan and the activities of the Soviet Union in other areas. We've had testimony before this committee year after year about Soviet difficulties in obtaining hard currency. We have had testimony from defectors over and over and over again about how much it costs us in our own military budget—which is now being attacked in the name of deficit reduction—about billions of dollars to defend against our own technology, and yet the export of credit is one of the most serious problems of all because it helps the Soviets buy our technology.

When we help out that economy, when we get hard dollars into the Soviet Union and we see $1½ billion a year being spent by the Soviets to get our sensitive technology, I'm sorry, but I don't understand why U.S. banks have to make loans of that kind. As a matter of fact, when I said this is a moderate bill, it is. I would like to go much further personally if I thought I could do it and prohibit the loans, especially when we've got an agricultural crisis in this country. We've got the Farm Credit System failing and we've got agricultural banks that are on their backs, farmers that are on their backs, and we make low-interest loans to the Soviet Union to finance pipelines, as we did with the Yamal pipeline.

So let it go out from this room that this is a serious effort and that this bill will be pushed because there has not been sufficient response from U.S. banks. I'm sure you've got plenty of places to loan the money in this country. You don't need to run outside the country. You've got enough debt problems with South and Central America as well. Start putting the interests of this country first.

I'm sorry if I'm too blunt for some of you, but that's just too bad. This bill will be pushed and it will be pushed very hard to give the President that authority and if that isn't enough we'll try to push legislation to prohibit loans to countries of this type.

[Copy of proposed bill follows:]

99TH CONGRESS
1ST SESSION

S. 812

To amend the Export Administration Act of 1979 to authorize controls on the export of capital from the United States.

IN THE SENATE OF THE UNITED STATES

MARCH 28 (legislative day, FEBRUARY 18), 1985

Mr. GARN (for himself and Mr. PROXMIRE) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To amend the Export Administration Act of 1979 to authorize controls on the export of capital from the United States.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Financial Export Control Act".

SEC. 2. Section 2 of the Export Administration Act of 1979 is amended by adding at the end thereof the following:

"(10) Loans and other transfers of capital to the Soviet Union and its allies from public and commercial sources significantly increase the ability of those countries to obtain sensitive goods and technology, thereby damaging the security interests of the United States and its allies.".

SEC. 3. Section 3 of the Export Administration Act of 1979 is amended—

(1) in paragraph (2)(B), by striking out "and" after the semicolon;

(2) in paragraph (2)(C), by striking out the period and inserting in lieu thereof "; and "; and

(3) by adding at the end of paragraph (2) the following:

"(D) to restrict the export of capital, the extension of credit, the making of loans, or the transfer of financial resources to destinations to which exports are restricted in order to carry out the policy described in subparagraph (A) of this paragraph.".

SEC. 4. The Export Administration Act of 1979 is amended by inserting after section 8 the following new section:

"CAPITAL CONTROLS

"SEC. 8A. (a) AUTHORITY.—In order to carry out the policy set forth in section 3(2)(D) of this Act, the President may prohibit, curtail, monitor, or otherwise regulate the export or transfer, or participation in the export or transfer, of money or other financial assets, including the making of a loan or the extension of credit, to the government of any controlled country, or to any political subdivision thereof or any organization or association owned by or acting for or on behalf of such government or political subdivision thereof. The authority contained in this subsection shall be exercised by the Secretary of the Treasury, in consultation with the Secretary of Defense, the Secretary of Commerce, and such other departments and agencies as the Secretary of the Treasury shall consider appropriate.

"(b) Negotiations With Other Countries.—The Secretary of the Treasury, in consultation with the Secretaries of State, Defense, and Commerce, and the heads of other appropriate departments and agencies, shall be responsible for conducting negotiations with other countries regarding their cooperation with controls imposed pursuant to subsection (a).".

Sec. 5. Section 10 of the Export Administration Act of 1979 is amended—

(1) in subsection (a)(1), by striking out "All export license applications" and inserting in lieu thereof "Except as provided in subsection (k), all export license applications";

(2) in subsection (j)(1), by inserting before the period ", except in the case of any license that may be required pursuant to section 8A of this Act, in which

case the Secretary of the Treasury shall establish such procedures"; and

(3) by adding at the end thereof the following new subsection:

"(k)(1) Any export license applications required pursuant to section 8A of this Act shall be submitted by the applicant to the Secretary of the Treasury. All determinations with respect to any such application shall be made by the Secretary of the Treasury.

"(2) To the extent necessary, the Secretary of the Treasury shall seek information and recommendations from the Government departments and agencies concerned with aspects of the United States domestic and foreign policies and operations having an important bearing on the policy set forth in section 3(2)(D) of this Act.".

SEC. 6. Section 12 of the Export Administration Act of 1979 is amended—

(1) in the second sentence of subsection (c)(1), by inserting before the period the following: ", or in the case of information obtained with respect to section 8A of this Act, unless the Secretary of the Treasury so determines"; and

(2) in subsection (e), by striking out "The Secretary" and inserting in lieu thereof "Except with regard

to the authority provided under section 8A(a), the Secretary".

SEC. 7. Section 14(a) of the Export Administration Act of 1979 is amended—

(1) by striking out "and" at the end of paragraph (19);

(2) by striking out the period at the end of paragraph (20) and inserting in lieu thereof "; and"; and

(3) by adding at the end thereof the following:

"(21) actions taken by the President and the Secretary of the Treasury to carry out the policies set forth in section 3(2)(D) of this Act, as described by the Secretary of the Treasury in a report submitted for inclusion as a part of the Secretary's annual report required by this section.".

SEC. 8. Section 15 of the Export Administration Act of 1979 is amended by inserting "and the Secretary of the Treasury" after "Secretary".

SEC. 9. Section 16 of the Export Administration Act of 1979 is amended—

(1) in paragraph (4) by striking out "and" after the semicolon;

(2) in paragraph (5) by striking out the period and inserting in lieu thereof a semicolon; and

(3) by adding at the end thereof the following:

"(6) the term 'extension of credit' includes loans, credit sales, the supplying of funds through the underwriting, distribution, or acquisition of securities, the making or assisting in the making of a direct placement, or otherwise participating in the offering, distribution, or acquisition of securities; and

"(7) the term 'loan' includes any type of credit, including credit extended in connection with a credit sale.".

The CHAIRMAN. Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you, Mr. Chairman. I am delighted to hear your very, very strong statement.

On March 28, Mr. Chairman, you introduced S. 812, the Financial Export Control Act, a bill of which I'm a cosponsor.

That bill, which is the subject of our hearing here today, would amend the Export Administration Act in order to give the President the authority to control bank loans and other extensions of credits from American banks and corporations to the Soviet Union and its Eastern bloc allies.

On April 1, I made a floor statement in support of this bill. I noted that it is designed to enable the executive branch to more carefully review extensions of credit to the Soviet bloc in order to help achieve some of our political objectives vis-a-vis the harsh Soviet rule in Eastern Europe.

Let me emphasize, Mr. Chairman, that this bill does not cut off bank loans to the Soviet bloc. It authorizes but does not direct the President to control transfers of capital to countries against which we maintain national security export controls; that is, the Soviet bloc countries.

Under the bill the President would be given the authority to apply such controls in the manner most in keeping with our national interests.

Two years ago when we had hearings in the Banking Committee to guide us in crafting amendments to the Export Administration Act we heard credible testimony about the Soviet Union's massive, well-managed, and carefully targeted Technology Acquisition Program. They spend a whale of a lot of money trying to get our militarily critical technologies. Their program enables the Soviets to save both time and money in their military R&D Program.

It's interesting that just this year we were informed by the Under Secretary of Defense for Research that we lead the Soviet Union in 15 of the 20 most important technological areas. They lead in none. The way they're able to keep pace, of course, is by acquisition one way or another, by stealing, by buying, or by some way of securing the technology that we advance. They have their own very highly competent technology but it's behind ours and we should take advantage of that.

To counter this advantage they illegally and surreptitiously purchase military technologies we develop at considerable expense to our taxpayers.

This last week the Secretary of Defense released an updated report on this matter which said:

> The magnitude of the Soviet collection effort and their ability to assimilate collected equipment and technology are far greater than was previously believed.

We have tried to slow down this hemorrhage of our critical technology to the Soviets with changes we made to the Export Administration Act which became law in June. An additional amendment to the act to provide for more careful review of loans by United States banks to the Soviet bloc as provided in S. 812 might help reduce the amount of discretionary dollars the Soviets have available to fund their clandestine technology acquisition efforts.

On May 20-21 of this year, the Eighth Session of the Joint U.S.-U.S.S.R. Commercial Commission which was established by President Nixon in May 1972 was held in Moscow. Secretary Baldrige said that the United States wants to establish a more constructive working relationship with the Soviet Union and that an expansion of trade can be part of such relationship.

The Soviets in reply said that they were opposed to tying trade to aspects of bilateral relations which have no bearing on trade.

Well, I disagree absolutely with that Soviet view. I believe trade with the Soviet Union should be supervised by our Government and handled as part of our strategic dialog with that country. I believe that more careful review and management of extensions of credit to the Eastern bloc will better serve U.S. interests.

Certainly the Soviet Government does not turn a blind eye to the political impact of its trade and credit deals with the United States. Our Government should likewise be aware and have a voice in approving credit deals as it does exports of goods to the Soviets.

I agree with Senator Garn, the chairman, that it is time to address the issue of credit extensions to the Soviet bloc and I'm delighted to cosponsor this bill for the reasons stated.

Mr. Chairman, I'm going to have to leave before we finish the hearing today. I don't think I'll be here in time to ask questions, but I do have some questions which I would appreciate if the witnesses could answer for the record.

The CHAIRMAN. Thank you, Senator Proxmire.

Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, I very much appreciate your scheduling today's hearing in which we will be addressing the important issues regarding the extension of U.S. credit to Warsaw Pact countries. I share the frustration that is felt not only by the cosponsors of this legislation, but by many Americans who are outraged that we provide vitally needed currency in the form of loans to East European Communist nations. Our sense of outrage is further heightened by the illegal transfer of technologically sophisticated information to those nations; an act often facilitated by Western loans.

The timeliness of this hearing is demonstrated by the recent release of an updated report by Secretary of Defense Weinberger on the acquisition of militarily significant Western technology by the Soviet Union. This report details the extent of Soviet successes in unlawfully acquiring vital technology from the United States for its arms buildup. The United States has kept a technological edge on the Soviet Union, but we are losing our advantage, due in part to the unlawful transfer of advanced and sensitive technology to Soviet bloc nations. To obtain this technology, as you have pointed out, the Soviets and their client states must pay for the technology with foreign currencies that are not readily available in nations dependent upon nontraded currencies. S. 812, the Financial Export

Control Act, addresses this growing and increasingly threatening problem.

S. 812 addresses the problem attendant to providing Eastern bloc nations with foreign currency by giving the President the power to control the transfer of capital to these nations. This will expand similar Presidential powers under the International Emergency Economic Powers Act.

Earlier in this decade, U.S. banks were the first to curtail lending to Eastern bloc nations. The termination of these loans was due in part to internal political pressure in the form of human rights concerns and to the fact that these countries were poor credit risks. Recently, however, U.S. banks have resumed lending to Eastern bloc nations. Apparently, U.S. banks have determined that these countries are now better credit risks. The resumption of loans to Eastern bloc nations cannot be tied, however, to an improved human rights record and, as chairman of the Helsinki Commission on Human Rights, the resumption of lending indicates that human rights violations play little role in determining a nation's eligibility for U.S. credit and capital. We must set some consistent standards to determine the conditions that must be present before we provide loans to these nations. Recently the President, under pressure from the Congress, banned new bank loans to the Government of South Africa because of its regrettable human rights record. United States policy in this area appears inconsistent if exceptions are made for nations like the Soviet Union which routinely trade in goods produced by slave labor and ruthlessly persecutes its Jewish citizens and dissidents.

Clearly, the issues regarding the lending of U.S. capital to Eastern bloc Communist nations are not easily resolved. On the one hand, Western industrialized nations want to foster trade with Warsaw Pact countries to ease world tensions and to improve the world economy. Alternatively, we do not want to give to the Soviet Union and its satellites the means by which they can illegally purchase our technology.

I commend Chairman Garn and Senator Proxmire for bringing these issues to the attention of this committee and the Senate and I am prepared to support what I think is a very viable solution to this problem.

The CHAIRMAN. I thank the Senator from New York.

Senator Mattingly.

OPENING REMARKS OF SENATOR MATTINGLY

Senator MATTINGLY. Mr. Chairman, I have no formal statement except to say that I think the legislation that's been offered by yourself and Senator Proxmire has been a long time in coming and I just wish that we could pass it today and enforce it today. I think all of us agree that something needs to change the way we're doing business with certain nonmarket economy nations, especially when you're talking about hard currency loans and transactions.

The CHAIRMAN. Senator Hecht.

OPENING REMARK OF SENATOR HECHT

Senator **Hecht**. Thank you, Mr. Chairman. I like what you said. In the essence of time, I just have one comment. Would you list me as a cosponsor of your legislation?

The **Chairman**. We would be happy to.

Senator Gorton.

Senator **Gorton**. No opening statement, Mr. Chairman.

The **Chairman**. Our first witness, Mr. Richard V. Allen, former Assistant to the President for National Security Affairs. Dick, we're happy to have you before us this morning, if you would like to proceed.

STATEMENT OF RICHARD V. ALLEN, FORMER ASSISTANT TO THE PRESIDENT FOR NATIONAL SECURITY AFFAIRS

Mr. **Allen**. Thank you, Senator.

Mr. Chairman and members of the committee, I appreciate this opportunity to share some thoughts with you on the proposed legislation which I find to be of great importance to the Nation. I support this bill, Mr. Chairman, not only because I consider it a very valuable addition to the arsenal of the President to guide and keep close control of our relations with Communist and other adversary nations, but also because it makes good strategic sense for the United States. I also believe that insightful legislation like this is long overdue.

ACT WILL STEM THE FLOW OF FUNDS TO COMMUNIST NATIONS

Once enacted and used by the President in support of the Nation's broad foreign policy objectives, the powers granted him in this proposed legislation will bring into focus certain activities by the private sector that have a direct relationship to our national security. Now, and in the past, we have had no effective means to stem the flow of money and credits to countries that pursue policies that are inimical to U.S. interests and that may jeopardize American lives and property.

As a student of East-West relations for nearly 30 years—and I might add, as a person interested in the subject of East-West trade for a long period of time, having published one of the first studies on the strategic implications of East-West trade as early as 1964—I have more than once wondered why we insist on funding and supporting the economies of nations whose avowed purpose it is to destroy our way of life, and who possess the means to do just that. Fortunately, we have now reached a point in the national dialog at which it is possible to raise such issues without evoking emotional responses from those who usually consider such talk to represent a primitive and inarticulate anticommunism.

I understand that you are troubled by the increasing involvement of United States banks in loan syndications to Eastern European countries, allies of the Soviet Union and members of the Warsaw Pact, and on terms substantially more favorable than those available to, say, the average American in search of a home mortgage. This appears to represent a reversal of a trend established in recent years, and signals a broad intention by those banks to involve themselves in what they perceive to be economic opportunities in the East.

It has long been clear to me, Mr. Chairman, that American lenders to the Communist countries, including the Soviet Union when it was fashionable and permissible to do so without criticism, either have not the faintest conception of the relationship of their actions to our national security or simply do not care.

There is a variation of this latter possibility—namely, they do indeed understand that relationship, but are prepared to defend their actions by asserting they are not making loans to support the military sector of the Warsaw Pact countries, but are making loans only to the peaceful, civilian sectors. Hence, their loans are justified in the national interest because if we do not get the business, some lucky Japanese or European banks will.

Such arguments don't stand up to the test of reality. They remind one of the same persuasive rhetoric these friendly and peripatetic bankers used during the rapid expansion of their international lending activities in the Third World, and especially in Latin America. Armed with loan applications, swarms of bankers, young and those who knew better, descended upon the capitals of these willing nations, offering the resources of industrial America and declaring that the loans were indeed safe, good risks because they represented sovereign debt, and, as everyone knows, sovereign debt can never be repudiated.

The same weak, and equally invalid, arguments are made today. The Soviet Union, they say, will never let an East European country default and will itself step in to backstop a tottering client state so as to protect its own creditworthiness.

But let us set aside the question of financial risk and whether these loans will actually be repaid and turn to the issue of the application of the proceeds of such loans. Even if we were to accept the fiction that our bankers don't lend for the purpose of helping the military sectors of Communist economies, will they at least acknowledge that, to the extent pressures upon the grossly inefficient and corrupt civilian economy are relieved, such aid represents an injection of needed resources to the power sector?

The concept embodied by the bill before this committee, Mr. Chairman, is one that puts an end to the ridiculous and dangerous posturing on this critical issue. Underlying whatever rhetoric is offered to justify the rejection of this bill is the notion that we can treat the Warsaw Pact countries as we do our other trading partners, and that normal commercial relations are highly desirable.

BANKERS ARGUE THEY HAVE SUPPORT OF THE U.S. GOVERNMENT

During the zenith of the détente era, bankers could indeed argue that their actions had the full support of the U.S. Government. Lamentably, this was true, and especially during the Republican years of 1968–76, although the genesis of the problem is more correctly located in the 1960's. The history of this remarkable period, while interesting and highly relevant, can be the subject of our later question period, Mr. Chairman, but I do think it important to make the point that the root causes of our persistent mistakes and miscalculations in the past can be traced directly to the flawed notions that formed the intellectual basis for U.S. policy during the 1960's and 1970's. Unless we understand this important past, we will not be in a position to understand the present or make intelligent policy choices for the future.

Two brief examples: First, the myth of an independent and westward-migrating Romania. Here we have the example of one of the more successful public relations jobs of modern times. As the split between the Soviet Union and China began to develop in earnest during the 1960's, the Romanian leader Ceaucescu saw an interesting opening. He cleverly kept open his lines to Peking and resisted Soviet demands. This was no insignificant step, and it caught the attention of the Western press. If Ceaucescu could stand up to Brezhnev and Kosygin, we thought, and if he is as keen on maintaining Romania's independence from the Soviet Union as he appears to be, or appeared to be, then certainly he must be our kind of fellow. And, if he represents an opportunity for the West, he's probably a genuine liberal who can crack the iron curtain. Once ensconced on the cover of Newsweek and Time, the rest was relatively easy and the credits began to flow.

Now if we examine the record of two decades of Western attention, sympathy and financial assistance to Romania, can we conclude that human rights, basic freedoms and the standard of living have improved? Certainly not. Repression and persecution continue, and the Romanian people are as bad off, if not worse, as they were in 1965.

Does Romania maintain its independent stance toward Moscow? The answer is that in some respects it does, and others it does not. Romania continues to align itself with Moscow on major international issues, and our influence there has not grown in any measurable degree. At the same time, Romania's ability to attract Western aid has significantly reduced the economic burden for the Soviet Union and actually strengthened Ceaucescu's Communist dictatorship.

In stark terms, Romania is still an asset for the East, and not for us. Despite the unfulfilled expectations of our policy with respect to this small country, some believe we should continue to confer economic benefits upon it. This is hard for most objective people to understand, even though practically everybody agrees that we should continue to trade with Romania, a view which I also share.

My second example is a bit more personalized. It materialized as a result of the intense maneuvering in late 1971 and early 1972, just prior to the Nixon visit to Moscow.

The Soviet Union, sensing a splendid economic opportunity in the forthcoming phase of the thaw in our relations, invited scores of American businessmen to Moscow for the purpose of dangling under their noses some very large orders. As I was at the time Deputy Assistant to the President for International Economic Affairs in the White House, I encountered many of these businessmen—many were directed to the White House by the Soviets themselves—who came to plead for the blessing of the White House upon Export-Import Bank credits and most-favored-nation status for the Soviet Union.

BUILDERS OF RUSSIAN TRUCK MANUFACTURING FACILITY

Among those who presented themselves, armed with the endorsement of Members of Congress, were the companies being romanced by the Soviets to build a turnkey truck manufacturing facility. To the question concerning the end use of the trucks and the implication that they might be used for military purposes, the American businessmen waxed indignant, assuring us that these were to be peaceful trucks, the type that would haul cement, vegetables, lumber, and other commodities, and would most assuredly not be suitable for Soviet military needs.

As to how the Soviets were to pay for this state-of-the-art truck manufacturing plant, we were told that the financing by American banks was a sure thing.

We fought that internal battle for many months, Mr. Chairman, and those of us who objected that this was a dangerous venture were overruled, specifically by our colleague, Mr. Kissinger, then National Security Adviser. The proponents of the transaction were very eager for it to go forward, principally because it was to be another of those deals that would give us leverage over the Soviet Union's international behavior.

As the hopes of stopping the deal ebbed, I wrote a memorandum to the President to the effect that this would be a bad decision and that some day the trucks manufactured at this facility would carry Soviet troops and their supplies to a destination at which we would not want them to be.

You've probably guessed by now what I'll say next. The truck plant was to be built near the Kama River and came to be known as the Kama River truck plant. It was ultimately completed with multinational help, not exclusively American but also including American assistance. And in 1979, it was trucks from this very Kama River plant that carried Soviet troops into Afghanistan. To this day, those Kama River trucks continue to supply the brutal Soviet occupation of Afghanistan, but we're no longer much concerned about that past mistake and so we don't hear much about it.

These examples do stray a bit from your specific topic of inquiry this morning, Mr. Chairman, but I think they are relevant to your overall approach to the subject of capital controls on loans to the Eastern bloc countries. The point I should like to make is that the proper focus of your consideration ought to be the broad, strategic context of East-West relations, and not just the narrow issue of an apparent technical nature.

We need to keep in mind that when we are dealing with the Eastern European countries, we are in fact dealing with nations that are aligned with and are often subservient to Moscow, do its bidding under the ever-present threat of direct intervention, and oppose the United States and its allies at every turn. Why should we make it easier for such nations to borrow Western capital at attractive rates when we know that the effect will be to strengthen our adversaries?

However, if for some reason that we deem it in our national interest to extend credit facilities to such nations, would it not be reasonable that the discretionary authority to approve such loans rest with the President of the United States? He is uniquely qualified to assess the significance of a proposed loan to an adversary nation within the larger fabric of our national interest and his policy objectives, and in any event is infinitely more qualified to do so than is a banker in New York or Chicago.

Mr. Chairman, there is much more to be said about this issue, but I prefer to end my formal statement at this point and enter into a discussion about the issues I have raised and others that are on the minds of the chairman and other committee members.

In closing, however, I should like to call attention to something you've already called attention to; that is, the new and extraordinary study released by Secretary of Defense Weinberger entitled, "Soviet Acquisition of Militarily Significant Western Technology." This landmark study, perhaps the word "bombshell" study would be more appropriate, lays out in incredible detail the extraordinary threat posed to the West by Soviet and East European intelligence services. Members of the committee have already quoted from the document but I ask your permission to quote out loud two significant paragraphs at the front of the study. They are:

> In recent years, the United States Government has learned of a massive, well-organized campaign by the Soviet Union to acquire Western technology illegally and legally for its weapons and military equipment projects. Each year Moscow receives thousands of pieces of Western equipment and many tens of thousands of unclassified, classified and proprietary documents as part of this campaign. Virtually every Soviet military research project, well over 4,000 each year in the late 1970's and over 5,000 in the early 1980's, benefits from these technical documents and hardware. The assimilation of Western technology is so broad that the United States and other Western nations are thus subsidizing the Soviet military buildup. Western products and technology secrets are being systematically acquired by intricately organized, highly effective collection programs, specifically targeted to improve Soviet military weapons systems. The Soviet intelligence service, the KGB and the GRU and their surrogates among the Eastern European services and Soviet trade and scientific organizations are actively involved in obtaining this technology. Targets include defense contractors, manufacturers, foreign trading firms, academic institutions, and electronic data bases. Only recently has the full extent of illegal Soviet technology collection efforts become known.

This was a significant study and it is the result of the work of Secretary Weinberger and Assistant Secretary for International Security Policy Richard Perle. They deserve to be commended for this important study, Mr. Chairman, and I request that the entire study, the accompanying statement by Secretary Weinberger, the briefing by Assistant Secretary Perle and the fact sheet be included in the record of this hearing.

Thank you, sir.

The CHAIRMAN. Without objection, it will be included.

[The complete prepared statement and the administration study entitled, "Soviet Acquisition of Militarily Significant Western Technology: An Update" follow:]

STATEMENT OF RICHARD V. ALLEN**

Senate Committee on Banking, Housing and Urban Affairs

September 26, 1985

Mr. Chairman and Members of the Committee:

Thank you for your invitation to present my views on S. 812, denominated as a bill authorizing the President to control the transfer of money and other financial resources from the United States to countries against which we maintain national security export controls.

To put it succinctly, Mr. Chairman, I support this bill not only because I consider it a very valuable addition to the arsenal of the President to guide and keep close control of our relations with communist and other adversary nations, but also because it makes good strategic sense for the United States. I also believe that insightful legislation like this is long overdue.

Once enacted and used by the President in support of the nation's broad foreign policy objectives, the powers granted him in this proposed legislation will bring into focus certain activities by the private sector that have a direct relationship to our national security. Now, and in the past, we have no effective means to stem the flow of money and credits to countries that pursue policies that are inimical to U.S. interests and that may jeopardize American lives and property.

As a student of East-West relations for nearly thirty years, I have more than once wondered why we insist on funding and supporting the economies of nations whose avowed purpose it is to destroy our way of life, and who possess the means to do just that. Fortunately, we have now reached a point in the national dialogue at which it is possible to raise such issues without evoking emotional responses from those who usually consider such talk to represent a primitive and inarticulate "anti-communism."

I understand that you are troubled by the increasing involvement of U.S. banks in loan syndications to Eastern European countries, allies of the Soviet Union and members of the Warsaw Pact, and on terms substantially more favorable than

those available to, say, the average American in search of a home mortgage. This appears to represent a reversal of a trend established in recent years, and signals a broad intention by those banks to involve themselves in what they perceive to be economic opportunities in the East.

It has long been clear to me, Mr. Chairman, that American lenders to the communist countries, including the Soviet Union when it was fashionable and permissible to do so without criticism, either have not the faintest conception of the relationship of their actions to our national security or simply do not care.

There is a variation of this latter possibility -- namely, they do indeed understand that relationship, but are prepared to defend their actions by asserting they are not making loans to support the **military** sector of the Warsaw Pact countries, but are making loans only to the **peaceful, civilian** sectors. Hence, their loans are justified in the national interest, because if we do not get the business, some lucky Japanese or European banks will.

Such arguments don't stand up to the test of reality. They remind one of the same persuasive rhetoric these friendly and peripatetic bankers used during the rapid expansion of their international lending activities in the Third World, and especially in Latin America. Armed with loan applications, swarms of bankers, young and those who knew better, descended upon the capitals of these willing nations, offering the resources of industrial America and declaring that the loans were indeed safe, "good risks" because they represented "sovereign debt," and, as everyone knows, "sovereign debt can **never** be repudiated."

The same weak, and equally invalid, arguments are made today. The Soviet Union, they say, will never let an East European country default, and will itself step in to backstop a tottering client state so as to protect its own creditworthiness.

But let us set aside the question of financial risk and whether these loans will actually be repaid, and turn to the issue of the application of the proceeds of such loans. Even if we were to accept the fiction that our bankers don't lend for the purpose of helping the military sectors of communist economies, will they at least **acknowledge that, to the extent pressures upon the grossly inefficient and corrupt**

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"civilian" economy are relieved, such aid represents an injection of needed resources to the **power sector**?

The concept embodied by the bill before this Committee, Mr. Chairman, is one that puts an end to the ridiculous and dangerous posturing on this critical issue. Underlying whatever rhetoric is offered to justify the rejection of this bill is the notion that we can treat the Warsaw Pact countries as we do our other trading partners, and that normal commercial relations are highly desirable.

During the zenith of the detente era, bankers could indeed argue that their actions had the full support of the U.S. Government. Lamentably, this was true, and especially during the Republican years of 1968-76, although the genesis of the problem is more correctly put in the 1960s. The history of this remarkable period, while interesting and highly relevant, can be the subject of our later question period, Mr. Chairman, but I do think it important to make the point that the root causes of our persistent mistakes and miscalculations in the past can be traced directly to the flawed notions and that formed the intellectual basis for U.S. policy during the 1960s and 1970s. Unless we understand this important past, we will not be in a position to understand the present or make policy for the future.

Two brief examples will suffice for the moment:

First, the myth of an independent and westward-migrating Rumania. Here we have the example of one of the more successful public relations jobs of modern times. As the split between the Soviet Union and China began to develop in earnest during the 1960s, the Rumanian leader Ceaucescu saw an interesting opening. He cleverly kept open his lines to Peking and resisted Soviet demands. This was no insignificant step, and it caught the attention of the Western press. If Ceaucescu could stand up to Brezhnev and Kosygin, we thought, and if he is as keen on maintaining Rumania's independence from the Soviet Union as he appears to be, then certainly he must be our kind of fellow. And, if he represents an opportunity for the West, he's probably a genuine liberal who can crack the iron curtain. Once ensconced on the cover of **Newsweek** and **Time**, the rest was relatively easy and the credits began to flow.

If we examine the record of two decades of Western attention, sympathy and financial assistance to Rumania, can we conclude that human rights, basic freedoms and the standard of living have improved? Certainly not; repression and persecution continue, and the Rumanian people are as bad off, if not worse, as they were in 1965.

Does Rumania maintain its independent stance toward Moscow? The answer is that in some respects it does, and others it does not. Rumania continues to align itself with Moscow on major international issues, and our influence there has not grown in any measurable degree. At the same time, Rumania's ability to attract Western aid has significantly reduced the economic burden for the Soviet Union and actually strengthened Ceaucescu's communist dictatorship.

In stark terms, Rumania is still an asset for the East, and not for us. Despite the unfulfilled expectations of our policy with respect to this small country, some believe we should continue to confer economic benefits upon it. This is hard for most objective people to understand, even though practically everybody agrees that we should continue to trade with Rumania (a view which I also share).

My second example is a bit more personalized: it materialized as a result of the intense maneuvering in late 1971 and early 1972, just prior to the Nixon visit to Moscow.

The Soviet Union, sensing a splendid economic opportunity in the forthcoming phase of the thaw in our relations, invited scores of American businessmen to Moscow for the purpose of dangling under their noses some very large orders. As I was at the time Deputy Assistant to the President for International Economic Affairs, I encountered many of these businessmen --many were directed to the White House by the Soviets themselves -- who came to plead for the blessing of the White House upon Export-Import Bank credits and "most-favored-nation" status for the Soviet Union.

Among those who presented themselves, armed with the endorsement of Members of Congress, were the companies being romanced by the Soviets to build a turn-key truck manufacturing facility. To the question concerning the end use of the trucks and the implication that they might be used for military purposes, the American businessmen waxed indignant, assuring us that these were to be "peaceful trucks," the type that would haul cement, vegetables, lumber and other commodities, and would most assuredly not be suitable for Soviet military needs.

As to how the Soviets were to pay for this state-of-the-art truck manufacturing plant, we were told that the financing by American banks was "a sure thing."

We fought that internal battle for many months, and those of us who objected that this was a dangerous venture were overruled, specifically by our colleague, Mr. Kissinger, then National Security Advisor. The proponents of the transaction were very eager for it to go forward, principally because it was to be another of those deals that would "give us leverage over the Soviet Union's international behavior."

As the last hopes of stopping the deal ebbed, I wrote a memorandum to the President to the effect that this would be a bad decision, and that some day the trucks manufactured at this facility would carry Soviet troops and their supplies to a destination at which we would not want them to be.

You've probably guessed by now what I'll say next: the truck plant was to be built near the Kama River, and came to be known as the Kama River Truck Plant. It was ultimately completed with multinational help, including American assistance. And in 1979, it was trucks from this very Kama River Plant that carried Soviet troops into Afghanistan. To this day those Kama River trucks continue to supply the brutal Soviet occupation of Afghanistan, but we're no longer very much concerned about that past mistake, and so we don't hear much about it!

These examples do stray a bit from your specific topic of inquiry this morning, Mr. Chairman, but I think they are relevant to your over-all approach to the subject of capital controls on loans to the Eastern bloc countries. The point I should like to make is that the proper focus of your consideration ought to be the broad, strategic context of East-West relations, and not just narrow issues of an apparent technical nature.

We need to keep in mind that, when we are dealing with the Eastern European countries, we are in fact dealing with nations that are aligned with Moscow, do its bidding under the ever-present threat of direct intervention, and oppose the United States and its allies at every turn. Why should we make it easier for such nations to borrow Western capital at attractive rates when we **know** that the effect will be to strengthen our adversaries?

However, if for some reason that we deem it in our national interest to extend credit facilities to such nations, would it not be reasonable that the discretionary authority to approve such loans rest with the President of the United States? He is uniquely qualified to assess the significance of a proposed loan to an adversary nation within the larger fabric of our national interest and his policy objectives, and in any event is infinitely more qualified to do so than is a banker in New York or Chicago.

Mr. Chairman, there is much more to be said about this issue, but I prefer to end my formal statement at this point and enter into a discussion about the issues I have raised and others that are on the minds of Committee Members.

In closing, however, I should like to call to the attention of the Committee the extraordinary study on **Soviet Aquisition of Militarily Significant Western Technology** released by Secretary of Defense Weinberger and Assistant Secretary for International Security Policy Richard Perle last week. In just 34 pages this landmark study -- perhaps the word "bombshell" would be more appropriate -- lays out in incredible detail the extraordinary threat posed to the West by Soviet and East European intelligence services. I ask your indulgence to permit me to read but two paragraphs from this concise study's summary, and I request that this study, the accompanying statement by Secretary Weinberger, the briefing by Assistant Secretary Perle and the Fact Sheet be included in the record of this hearing.

Soviet Acquisition of Militarily Significant Western Technology: An Update

September 1985

Soviet Acquisition of Militarily Significant Western Technology: An Update

In recent years, the United States Government has learned of a massive, well-organized campaign by the Soviet Union to acquire Western technology illegally and legally for its weapons and military equipment projects. Each year Moscow receives thousands of pieces of Western equipment and many tens of thousands of unclassified, classified, and proprietary documents as part of this campaign. Virtually every Soviet military research project—well over 4,000 each year in the late 1970s and over 5,000 in the early 1980s—benefits from these technical documents and hardware. The assimilation of Western technology is so broad that the United States and other Western nations are thus subsidizing the Soviet military buildup.

Western products and technology secrets are being systematically acquired by intricately organized, highly effective collection programs specifically targeted to improve Soviet military weapon systems. The Soviet intelligence services—the KGB, the GRU, and their surrogates among the East European services—and Soviet trade and scientific organizations are actively involved in obtaining this technology. Targets include defense contractors, manufacturers, foreign trading firms, academic institutions, and electronic data bases. Only recently has the full extent of illegal Soviet technology collection efforts become known.

The purpose of this paper is to reveal in detail the structure of these Soviet programs, and to give examples of Soviet requirements and successes. Understanding the Soviet effort is a critical first step in protecting Western technology and preventing it from being turned against the West.

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Soviet Acquisition of Militarily Significant Western Technology: An Update

Introduction

Overcoming considerable technological inferiority over the past several decades, the Soviets have built the largest military industrial manufacturing base in the world and a massive research establishment to complement it. Their objective is to achieve military-technical capabilities that are at least equal, if not superior, to those of the West.

Their resource commitment is enormous by any measure; it has enabled them in recent years to narrow the Western lead in nearly all key technological areas, particularly microelectronics. In materials, explosive, and sensor technologies applicable to deployed tactical forces such as tanks, artillery, and antitank and surface-to-air missiles the Soviets' technology level is roughly equal to or slightly better than that of the West. They are the world's leaders in a few significant fields, such as chemical warfare and in some areas of laser research for future "star wars" applications.

Nevertheless, in spite of the several decades of massive investment in indigenous research and development, the prospects are small that the Soviets can reduce their dependence on a large variety of Western products and technology in this decade and the next without allowing the technological gap to widen. The main reasons for this continuing need are endemic to the Soviet system: the lack of adequate incentives, inflexible bureaucratic structures, excessive secrecy, and insularity from the West. Even if there were some major Soviet economic or managerial reforms, *no real lessening of the Soviet dependence on Western innovation is anticipated* as long as the USSR perceives the need for military-technological parity with the West, or the need for superiority.

The impact of this dependence could be even more important in the 1990s than it is today. The USSR has been compelled to follow Western direction in technological change, and thus far it has been able to do this satisfactorily because of a mature technological base. The next decade is less certain for the Soviets, however, because of new technological leadership that the West has supplied them. Their dependence is essentially for *innovation*—where they will continue to look to the West—not for maintaining *adequacy*, which they have achieved in nearly all important military technologies. ***But today's adequacy will be tomorrow's obsolescence if technology fails to keep pace.***

In May 1982 the US Congress was given a report identifying a massive and global Soviet program to acquire Western militarily significant technology.[1] That report described the Soviets' successes in supplementing their military research and manufacturing capabilities and in narrowing the technology gap with the West, thereby eroding the technological superiority on which US and Allied security depends.

The identification of this Soviet program led the West to undertake greater efforts in counterintelligence and export control. Since then, it has become even more evident that the magnitude of the Soviets' collection effort and their ability to assimilate collected equipment and technology are far greater than was previously believed.

This update of the 1982 report defines the scope of the Soviet effort. It outlines how the Soviets go about acquiring Western technology and identifies examples of specific technologies they seek. It highlights details and statistics of Soviet successes—much more detail than could be revealed previously. This information was obtained directly by the United States and Allied countries. Understanding the Soviet effort is critical in designing ways to protect Western technology from being acquired and used against Western security interests.

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[1] *Soviet Acquisition of Western Technology*, April 1982. Exhibit No. 1, Hearings Before the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, Ninety-Seventh Congress, Second Session, 4, 5, 6, 11, and 12 May 1982.

[2] Western technology (hardware, documents, and know-how) includes that of Japan as well as other Free World countries.

Soviet Motivations

A basic question is why do Soviet weapon designers and Soviet manufacturers need to copy design concepts embodied in Western equipment and associated documents? In general, Soviet weapons have historically reflected a commitment to functional designs that can be easily manufactured in labor-intensive factories and readily maintained in the field with a minimum of technical skill. There has always been a struggle between Soviet design simplicity and technical complexity. Soviet weapon designers have not had to face the competitive pressures that drive Western designers to press the state of the art.

Building on a mature research sector and on lessons learned from past performances of weapons in battle, the Soviets are placing more of a premium on technically complex systems. Western system and equipment characteristics increasingly are used as yardsticks against which Soviet technical capabilities are judged. Every major civilian or military project is compared with the best Western technology before it is approved for development. Once in development, Soviet standards mandate the comparison of the quality and technical level of hardware, at different design stages, with foreign counterparts.

With their access to many details of Western weapons and dual-use equipment designs and concepts, Soviet designers are, in effect, competing with Western designers. That competition, supported and encouraged by the Soviet leadership, is probably pressuring the military research establishment to pay increasing attention to technically complex systems. Countervailing pressures for design simplicity are being applied by the manufacturing sector, which is less responsive in adapting to technological change. All of these forces indicate continuing Soviet programs to acquire Western military and dual-use hardware and technical data.

Overview of Two Soviet Programs

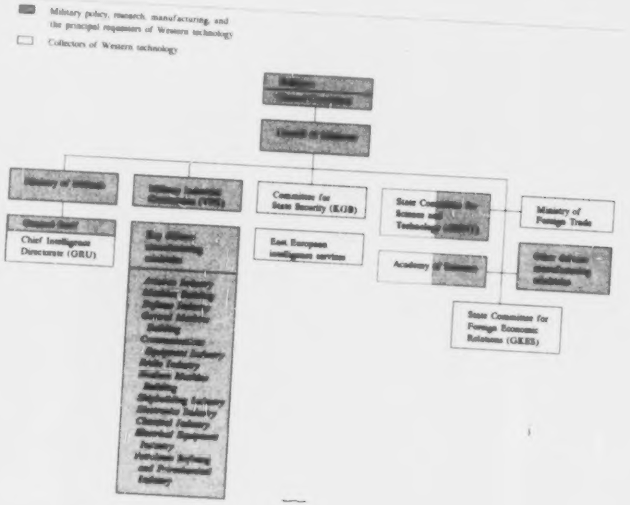
Since 1982 it has become clearer that the Soviets have two programs to acquire Western hardware and documents:

- First, Moscow has a program to raise the technical levels of weapons and military equipment as well as to improve the technical levels of manufacturing processes. This program is managed by the most powerful organization in defense production—the Military Industrial Commission (VPK) of the Presidium of the Council of Ministers (figure 1). Mainly, although not exclusively, through intelligence channels, the VPK seeks one-of-a-kind military and dual-use hardware, blueprints, product samples, and test equipment to improve the technical levels and performance of Soviet weapons, military equipment, and defense manufacturing equipment and reduce any dependency on advanced Western products. This is done in large part by exploiting and adapting design concepts embodied in acquired equipment and associated documents.
- Second, the Ministry of Foreign Trade and Soviet intelligence services administer a trade diversion program to acquire relatively large numbers of dual-use manufacturing and test equipment for direct use in production lines. This program seeks export controlled microelectronics, computer, communications, machining, robotics, diagnostic, and other equipment to increase the throughput of weapon-producing industries.

These two programs, which apparently are administered separately, are the hub of the Soviet effort.

The VPK program is principally, but not exclusively, an industrial security and counterintelligence concern for the West. It involves espionage by hostile intelligence officers, overt collection by Bloc officials, acquisition by scientific exchange program participants, and illegal trade-related activity. The trade diversion

Figure 1
Key Organizations Involved in Managing Military Research and Manufacturing and the Acquisition of Western Technology


Military policy, research, manufacturing, and the principal requesters of Western technology
Collectors of Western technology
Committee for State Security (KGB)
State Committee for Science and Technology
Ministry of Foreign Trade
Chief Intelligence Directorate (GRU)
East European intelligence services
Academy of Sciences
State Committee for Foreign Economic Relations (GKES)

The Military Industrial Commission (VPK) coordinates the development of all Soviet weapons as well as the Soviet national-level program to acquire Western technology. The VPK is the most powerful organization in the defense-research establishment, comprising the top executives of the key defense manufacturing ministries (industries). Requests for Western documents and one-of-a-kind hardware from military equipment designers in each of the 12 industries shown above are called requirements (see figure 2).

To satisfy these requirements, the VPK controls a national fund, amounting to some half a billion rubles each year (roughly $1.4 billion in 1980 purchase power equivalents). Once approved by the VPK, requirements are selectively levied among the KGB, the GRU, and at least four other national-level collection agencies, as well as surrogates among the East European intelligence services.

The State Committee for Science and Technology (GKNT) acts as a collector and as the central processor for the national-level program. It also monitors the absorption and assimilation of Western technology by the defense industries.

program principally involves export control and international compliance issues. Characteristics of these programs overlap, further complicating the design of adequate countermeasures:

- Both programs sometimes seek the same products.
- Soviet industrial ministries request technology and equipment through both programs.
- The collection channels overlap and in some cases the same Soviet individuals (intelligence officers and others) are involved in each program.

The VPK Program: Raising the Technical Levels of Weapons and Manufacturing Equipment

The VPK includes the top executives of most of the key Soviet defense manufacturing ministries shown in figure 1. Full VPK membership is given to the Ministers of Aviation, Machine Building (projectiles and explosives), Defense Industry (armor and electro-optics), General Machine Building (strategic missiles and space), Communications Equipment, Radio (radars and large-scale computers), Medium Machine Building (nuclear weapons and high-energy lasers), Shipbuilding, and Electronics. It is a small but powerful group, responsible for centrally overseeing the research, development, and production of all Soviet weapon systems. It coordinates developments between its chief customer, the Ministry of Defense, and the key suppliers, the defense-industrial ministries. As the expediter for weapons development projects, *it is the principal Soviet military instrument for eliminating or circumventing the inefficiencies characteristic of the Soviet economic system.*

As part of its responsibility to enforce schedules and to ensure that technical and performance specifications are met, the VPK translates requests for Western hardware and documents, principally by the design bureaus of 12 industries (figure 1), into lists of collection requirements. In the late 1970s alone about one-half billion rubles (roughly $1.4 billion in 1980 purchase power equivalents) each year was reserved for purchases of one-of-a-kind Western hardware and documents.

Three examples of specific requirements from the VPK lists are shown in figure 2. The first deals with the IBM 370 computer, used by the Soviets as the model for production of their own version, "Ryad," which is a copy of the IBM 370 architecture and functions. The second deals with a cruise missile computer. The VPK apparently assigned it a high priority because of major efforts under way at that time to develop long-range strategic cruise missiles, which require large-capacity digital memories for onboard navigation. The Soviets historically have had reliability and other problems in developing such computers. The third example is a US Fairchild Instrument Corporation/Xincom semiconductor memory tester. It is a good example of the one-of-a-kind dual-use product requested and acquired through the VPK program. Design concepts embodied in the hardware and associated documentation of the tester were copied to develop a Soviet counterpart. The original tester also could be used to help copy or reverse-engineer Western integrated circuits.

Requirements for documents alone can command amounts as considerable as hardware; examples include over 50,000 rubles (roughly $140,000 in 1980 purchase power equivalents) for documents on the US shuttle orbiter control system and over 50,000 rubles for high-energy laser developments. Over 200,000 rubles ($560,000) was approved for acquiring selected research documents on US antimissile defense concepts.

Each year the VPK publishes a report based on the evaluation of the individual ministries. It includes aggregate statistics on numbers of technical documents and samples (hardware) obtained, gross ruble savings, and the numbers and priority of requirements satisfied. This report is sent to the Chairman of the Presidium of the Council of Ministers and to the Central Committee of the Communist Party. Copies also are sent to headquarters elements of the collection organizations.

Figure 2
Examples of VPK Requirements, Mid 1970s - Early 1980s

Mid 1970s

Requester (responsible for producing mainframe computers)	1. Ministry of the Radio Industry
Desired technology	2. Technical documentation on IBM 370 computer models 145, 158, 168 and operating system data, not earlier than 1974. Information about new IBM projects.
Organization charged with collection	3. KGB
Origin or location of technology	4. US: Derivatives from the IBM firm

Late 1970s

Joint requirement. Priority code A-1 indicates technology needed for potential solutions of a problem in producing a future weapon system	1. Ministries of Aviation, Communications Equipment, and Electronics Industries; A-1, Most Critical
Desired technology	2. Electronic components and programing devices for cruise missile digital computer memory. Samples and documents desired.
Maximum funds allocated for collection of this item	3. 170,000 rubles
Organization charged with collection	4. KGB

Early 1980s

Code B-1 indicates substantial reduction in time and expenditure in production of new weapons	1. Ministry of the Electronics Industry, B-1
Desired technology	2. Xincom monitoring and mounting equipment for static and functional testing of semiconductor memory units. Sample and documents desired.
Maximum funds allocated for collection of this item	3. 4,500,000 rubles
A nonintelligence organization also charged with assisting collection	4. Ministry of Foreign Trade, KGB

The mid-1970s VPK requirement shown above targets IBM equipment for Soviet military research and development. The Soviets copied the architecture of the IBM 360 and 370 systems to develop their Ryad series of computers. The late 1970s requirement is a very high priority for three reasons: it is identified as "most critical"; it is needed to solve problems in producing a *future* weapon system; and *three* ministries would benefit technically, economically, and jointly from its acquisition. The early 1980s requirement, for a Fairchild/Xincom semiconductor memory test system, is a perfect example of the one-of-a-kind dual-use product (sample) and associated documentation requested for copying as well as for volume purchases for direct use in production lines. This tester was in fact acquired, and design concepts were copied, saving several hundred man-years of Soviet developmental effort.

Soviet requirement data also include the firms and sometimes the names of persons who have the desired hardware and documents. Some 3,000 to 5,000 new, amended, and reapproved requirements for hardware, documents, or both are now issued by the Soviets each year.

Table 1
Summary of Results of the VPK Program, Late 1970s and Early 1980s

- An average of over 5,000 Soviet military equipment and weapon system research projects per year in the early 1980s benefited from Western hardware and technical documents. Over half of these projects were in the electronics and the armor and electro-optics industries.
- Innovation, new concepts, new directions, higher technical levels of research, accelerated development of more advanced weapons, and the avoidance of major pitfalls are some of the key benefits to Soviet military scientific research projects.
- In the early 1980s more than 3,500 requirements were levied each year for specific Western hardware, documents, or both, with roughly one-third satisfied each year, the other two-thirds still targeted.
- Some half a billion rubles are maintained each year for potential collections against these requirements (roughly $1.4 billion in 1980 purchase power equivalents).
- During the 10th Five-Year Plan (1976-80), over 3,500 requirements were fully satisfied worldwide—roughly 60 to 70 percent of these being fulfilled by the Soviet intelligence services (the KGB and the GRU) and surrogates among the East European intelligence services. Requirements fully satisfied during the 11th Five-Year Plan will exceed 5,000.
- Of the 3,500 satisfied requirements approximately 5 to 10 percent were judged by the Soviets as the most significant to military research projects. The Soviet intelligence services and surrogates among the East European services fulfilled about 90 percent of these most significant requirements each year.
- About half of all VPK requirements fulfilled in the 10th Five-Year Plan (1976-80) and thus far in the 11th Five-Year Plan (1981-85) were for two industries: electronics and communications equipment.
- About 60 percent of that portion of document and hardware acquisitions considered to be the most significant to the Soviets was of US origin, although not necessarily collected in the United States.
- About 70 percent of the documents and hardware acquired in the 10th and so far in the 11th Five-Year Plans, which were judged by the Soviets to be the most significant to their military research projects, probably were export controlled, embargoed, classified, or under some control by Western governments.
- About 50 percent of the 6,000 to 10,000 pieces of hardware acquired annually and 20 percent of the 100,000 documents acquired annually are used by the Soviets in transferring Western technology into their military research projects.
- In the late 1970s about 700 embargoed dual-use manufacturing, diagnostic instrumentation, and other dual-use products were acquired each year for copying embodied designs, reverse-engineering, and probably for selected direct use as key equipment in Soviet military production lines.
- From 1976 to 1980 the greatest savings in research project costs, almost one-half billion rubles (the 1980 dollar cost of equivalent research activity would be $800 million), were realized by two ministries—the Ministry of the Defense Industry (armor and electro-optics) and the Ministry of the Aviation Industry. The Soviet manpower equivalence of these savings alone translates roughly into over 100,000 man-years of scientific research. These savings, however, may be biased. The ruble figures probably reflect operating costs—salaries, bonuses, and sometimes savings in elimination of, for example, test range activity, but not capital costs. Although Soviet managers generally tend to inflate savings to enhance their role, the savings estimated in the VPK program appear to be conservative.

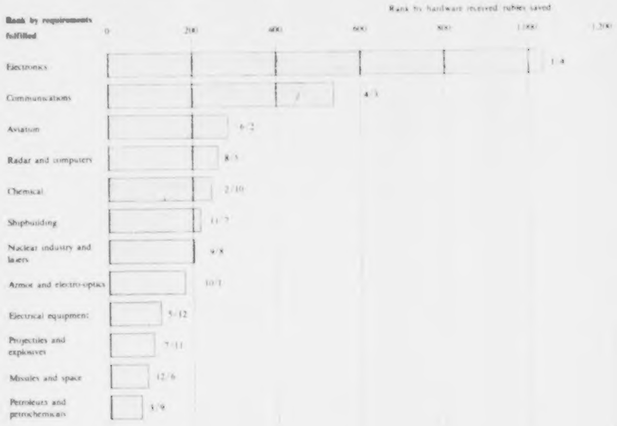
Successes and Benefits

The VPK program is a Soviet success story (table 1). Over 3,500 specific collection requirements for hardware and documents were satisfied for the 12 industrial ministries for just the 10th Five-Year Plan (1976-80). About 50 percent of more than 30,000 pieces of Western one-of-a-kind military and dual-use hardware and about 20 percent of over 400,000 technical documents collected worldwide in response to these requirements were used to improve the technical performance of very large numbers of Soviet military equipment and weapon systems. The benefits and distribution by industry of the fulfilled requirements are shown in figure 3.

According to the Soviets, about one-third of the VPK requirements are totally or partially fulfilled annually, strongly suggesting that Western industrial security, counterintelligence, export controls, and other efforts do have an effect. But each year the number of VPK requirements grows by about 15 percent. This is a strong indication that the expanding Soviet military industrial program continues to rely on Western technical solutions and advances. It also indicates increased collection success and user expectation.

Figure 3
Rank Ordering of Soviet Industries by VPK Requirements Fulfilled, by Rubles Saved, and by Hardware Received, 1976-80

Number of requirements for Western documents, hardware, or both



About 50 percent of the VPK requirements that were fulfilled during the 10th Five-Year Plan for Western hardware and documents were satisfied on behalf of two defense industries—electronics and communications. These are key areas where the Soviets' need for militarily significant technology and the West's need for better controls are greatest.

The four industries receiving the most Western military hardware and dual-use products were electronics (over 6,000 pieces of equipment, a large percentage involving microelectronics), chemical (almost 4,000 pieces), petroleum/petrochemicals (over 1,500), and communications (over 1,500), ranked in that order.

The top four industries saving the most rubles in research project development costs in terms of manpower and other resources were the armor and electro-optics industry (almost 20 percent of the 1.4 billion rubles saved in research project costs) and the aviation, communications, and electronics industries. These four industries consistently appear to be the Soviet leaders in requesting, absorbing, and generally getting the most use out of Western hardware and documents. In some cases, such as in the armor area, the Soviets are using Western technology not to catch up, but to enhance a capability that already is equal to or better than that of the West.

Five Years Gained in Developing the Next Generation of Fire-Control Radars for Soviet Fighter Aircraft

The Soviets estimated that by using documentation on the US F-18 fighter their aviation and radar industries saved some five years of development time and 35 million rubles (the 1980 dollar cost of equivalent research activity would be $55 million) in project manpower and other developmental costs. The manpower portion of these savings probably represents over a thousand man-years of scientific research effort and one of the most successful individual exploitations ever of Western technology.

The documentation on the F-18 fire-control radar served as the technical basis for new lookdown/shootdown engagement radars for the latest generation of Soviet fighters. US methods of component design, fast-Fourier-transform algorithms, terrain mapping functions, and real-time resolution-enhancement techniques were cited as key elements incorporated into the Soviet counterpart.

Moreover, F-18 and F-14 documentation served as the impetus for two long-term research projects to design from scratch a new radar-guided air-to-air missile system. The documentation also was instrumental in formulating concrete specifications to develop new Soviet airborne radar countermeasures equipment against the F-18 and F-14.

Significant acquisitions of Western technology include documents on fire-control radars for the F-14, F-15, and F-18 and documents on US ballistic missile defense concepts (table 2). In terms of broad defense programs, Soviet strategic missiles, air defense, tactical forces, and weapons manufacturing capabilities have benefited the most from the VPK program. The annex has several hundred examples of specific Soviet weapons and military equipment benefiting from Western technology.

Western technology collected each year in the late 1970s and early 1980s aided Soviet military industries principally in four ways. Ranked by priority, the VPK program:

- Redirected Soviet technical approaches in about a hundred projects each year for ongoing weapon systems and key military equipment, or resulted in the improvement of the weapons manufacturing processes.
- Initiated several hundred new short-term and long-term research projects each year on technical topics that had not been under consideration.
- Raised the technical levels of several thousand developmental projects each year involving military equipment, manufacturing, or design procedures.
- Eliminated or shortened phases of more than a thousand military research projects each year. This contributed to a substantial reduction—in a number of cases, two to three years—in time needed to produce more technically advanced weapons and military equipment.

The benefits vary from project to project. Western technology has assisted the Soviets in reducing their weapon acquisition cycle by up to two years for research projects in an advanced status. Acquisition of Western documents, for example, helped the Soviets cut by two years the time spent on researching a new generation of fuzes for munitions with a large kill radius and for self-aiming aviation cluster munitions. For projects in an earlier stage of research, the cycle can be reduced as much as five years. This considerably shrinks overall research time, reduces the amount of resources devoted to weapon system research, and allows diversion of those resources to other Soviet military research projects.

A wide range of Soviet data demonstrates that benefits to military research projects have increased significantly from the late 1970s to the early 1980s (figure 4) and have applied to thousands of research projects in all key defense industries. Measured in rubles, the

Table 2
Selected Worldwide Soviet Acquisitions, Military Applications, and Collectors of Western Documents, Military Hardware, and Dual-Use Products

Western Technology Acquired	Soviet Application/Improvement	Collector
Strategic Missiles		
Documents on Cruise Missiles Using Radar Terrain Maps	Cruise Missile Guidance	KGB, GRU
Documents on Heat Shielding Material for Reentry Vehicles	Ballistic Missile Warheads	KGB, GRU
Documents on Ballistic Missile Defense Concepts	Future Ballistic Missile Defense	KGB, GRU
Air Defense		
F-14, F-15, F-18 Documents on Fire-Control Radars	Four Soviet Fighter Aircraft	KGB, GRU
US Phoenix Missile Documents	Semiactive Air-to-Air Missile	KGB
Infrared Radiometer	Reduced Infrared Signature Aircraft	KGB
Fiber-Optics Systems	Aircraft and Missile Onboard Communication Systems	GRU
Air-to-Air Missile Documents	New Air-to-Air Missile	GRU
General Purpose Naval And Antisubmarine Warfare		
Aircraft Carrier Steam Catapult Design Documents	Aircraft Launching System for New Aircraft Carrier	GRU
US MK 48 Torpedo Documents	Antisubmarine Torpedo	GRU
Gamma Radiation Radiometer	Nuclear Submarine Wake-Detection Trailing System	GRU
Acoustic Spectrum Analyzer	Submarine Quieting	GRU
Powerful Acoustical Vibrator	Submarine and Ship Sonars	GKNT, GKES, Academy of Sciences
Space and Antisatellite Weapons		
Documents on Systems and Heat Shielding of the US Space Shuttle	Reusable Space System	KGB
Transit Naval Navigation Hardware	First-Generation Space-Based Naval Radionavigation System	GRU
US NAVSTAR Navigation System Documents	Digital Signal Processing for Counterpart Satellite System	Others
High-Energy Chemical Laser Documents	Space-Based Laser Weapon	KGB
System 101 Processing Equipment	Digital Processing and Video for Space-Based Reconnaissance; Missile, Bomb, and Remotely Piloted Vehicle Command Guidance	Others
Tactical Forces		
International Radar Conference Documents	Synthetic Aperture Radar for Aircraft Detection	GRU
Ground Support Equipment for US TOW Antitank Guided Missile	Countermeasure System	GRU
US Copperhead Laser-Guided Artillery Documents	New Laser-Guided Artillery Shell	GRU
Laser-Guided Missile Documents	Portable Antiaircraft System	KGB
Infrared Imaging Subsystem Designs	Fire-Control System of Future Tank	KGB
Millimeter Radar Documents	Antitank Missile	GRU
Pressure Measuring Instruments and Documents	Advanced Modeling for New Artillery Projectiles	KGB, GRU

Table 2
Selected Worldwide Soviet Acquisitions, Military Applications, and Collectors of Western Documents, Military Hardware, and Dual-Use Products (continued)

Western Technology Acquired	Soviet Application/Improvement	Collector
Manufacturing and Technology		
Kevlar 49 Fiber Documents for Missiles	Improved Missile Development	KGB, GRU
Complete Set of Manufacturing Equipment for Printed Circuit Boards	Copied for 11 Production Assembly Lines for Strategic Missile, Armor and Electro-Optics, and Radar Industries	Ministry of Foreign Trade
DTS-70 Printed Circuit Board Testing System	Military Microelectronic Production System	KGB
Fiberglass Manufacturing Technology	High-Pressure Airtanks for Submarines	KGB, GRU, Ministry of Foreign Trade
Computer Disk Memory Systems	Military Ryad Series Disk Drives	KGB
Bubble Memory Technology	Tactical Missile Onboard Memories	Others
Technical Documents on Tests of Cold-Rolled Steel	Improved Structural Protection of Warships	KGB
High-Accuracy Three-Dimension Coordinate Measuring Machine	Copied for Several Industries	Ministry of Foreign Trade, GKNT, GKES, Academy of Sciences

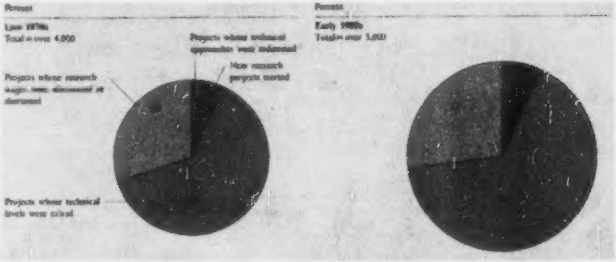
savings doubled between 1976 and 1980 (figure 5) and still are expanding in the 11th Five-Year Plan. The statistics on benefits also point to a massive diffusion of Western technology into Soviet military equipment and weapons. Figure 6 shows how the more than 5,000 military research projects benefiting in the early 1980s were distributed by industry. According to these rough indicators, the electronics, armor and electro-optics, and aviation industries are benefiting the most from Western technology.

Overall, the acquisition of Western technology permits the Soviets to field more sophisticated, versatile, and effective weapons. The basic time for fielding these advanced Soviet weapons, though, remains about the same. It also provides new military capabilities and allows additional resources to be used for the development of additional advanced weapons concepts. The acquisitions also serve to lighten somewhat the burden of continuing growth in Soviet research and defense spending.

Soviet copying and reverse-engineering of Western military and dual-use equipment are major characteristics of the VPK program. Indeed, the majority of VPK requirements for "technology" appears to be for hardware only. In the late 1970s alone, the Soviets acquired about 700 embargoed one-of-a-kind dual-use products each year principally in the area of manufacturing, inspection, instrumentation and test equipment, including key microelectronics production and test equipment. These products were used for making Soviet counterparts or possibly were for use as key manufacturing or test equipment that completed process lines. Examples included computer-controlled integrated circuit testers, aircraft engine vibration control systems, and narrow-band analyzers for submarine quieting.

These practices indicate Soviet deficiencies are in the design, testing, and integration of technologically advanced military systems, not in basic research and applied science. They fall short in the engineering of a device, technologically advanced by Western standards, into a useful piece of militarily applicable hardware producible in large quantities.

Figure 4
Technical and Time Benefits to Thousands of Soviet Military Research Projects From Western Technology



The benefits to the Soviet military research establishment from acquisitions of Western technology are far greater than previously believed. Virtually every Soviet long- and short-term research project for military systems—well over 4,000 in the late 1970s and well over 5,000 in the early 1980s—is benefiting from the documents and hardware of at least a dozen Western countries. (See figure 6 for a breakout of how these projects were distributed by industry.)

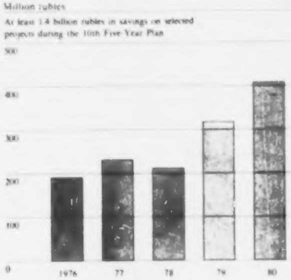
Projects in the VPK program are divided into the four major categories shown above. Projects with redirected technical approaches and new projects represent the most significant benefits through adoption of innovations and new directions for military systems. Major pitfalls are thus avoided. Projects whose technical levels were raised and those whose stages were eliminated or shortened represent improvements in the military state of the art of the Soviet Union and an acceleration in the time when more advanced subsystems are ready for new and future weapons.

The profile of the VPK program (as well as the trade diversion program) can be used to better define militarily critical technologies as well as better ways to counter Western losses. Both appear principally aimed at acquiring products and technical data. Both show that protecting dual-use products is just as important as protecting the related design know-how. Equipment sales divorced from the transfer of know-how do have long-term significance for the Soviets. The evidence indicates that equipment transfers, both large batch acquisitions and individual samples used for copying embodied design concepts and for reverse-engineering, generally outstrip acquisitions of "technology" in quantity and are of more immediate value to the Soviets.

VPK Collectors and Sources

Analysis of reliable data indicates that in the VPK program the Soviet Bloc intelligence services (the Soviet Committee for State Security (KGB), the Chief Intelligence Directorate of the Soviet General Staff (GRU), and their surrogates among the East European intelligence services) are the collectors most often tasked and the most successful.

Figure 5
Ruble Savings From Only a Part of Soviet Western Technology Acquisitions



The above savings generally are conservative estimates by the Soviets resulting from the elimination of stages of military research and design projects, the reduction in time to carry them out, and the adoption of new technical approaches. The savings are not cumulative. That is, a 20-million-ruble annual saving from the acquisition of US and other Western fiberglass plastics production technology used in manufacturing high-pressure air tanks for submarines was counted for one year only, the year of acquisition.

Roughly 400 million rubles ($640 million) were saved in 1980 for only a portion of the Western technology acquired. Most of these savings were in long-term military research projects for weapons of the late 1980s and early 1990s. They therefore were most likely given in terms of manpower savings. By this measure several tens of thousands of Soviet man-years of scientific research effort were saved in 1980.

During the late 1970s and early 1980s the Soviet intelligence services acquired, through their own efforts and those of the surrogate East Europeans, about 60 to 70 percent of all materials collected in the overall VPK program each year (figure 7). More important, these intelligence services were involved in collecting worldwide about 90 percent of the information judged by Moscow as most significant and used

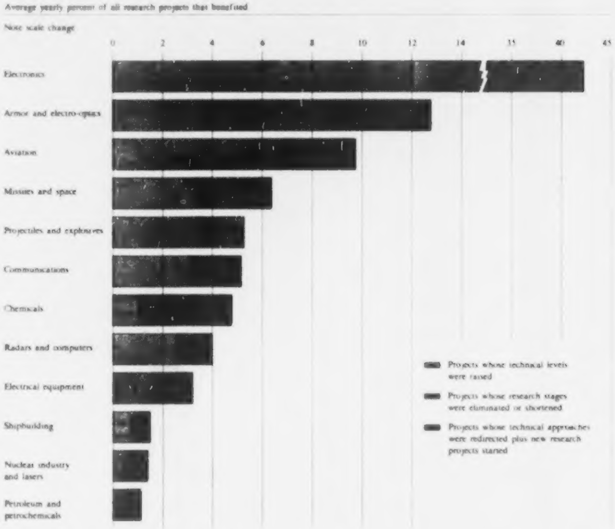
Microelectronics Reverse-Engineering

Soviet collectors have easily acquired many types of Western integrated circuits (ICs) for reverse engineering. Indeed, most Soviet ICs can be traced to a Western original. One of the best examples is their KR580IK80A microprocessor, which is a modified version of the Intel Corporation 8080A 8-bit microprocessor used in many US military systems. In this case, the Soviets even copied the equivalent US part number to avoid confusion (note the KR5 80 IK 80A versus the US 8080A).

Furthermore, the evidence clearly shows that Soviet ICs known as LOGIKA-2 and series 133/155 were directly copied from the Texas Instruments 5400/7400 family. These ICs have been used in Soviet strategic and tactical military systems since the mid-1970s to provide important qualitative improvements. The more advanced Western fabrication equipment acquired by the Soviets in recent years has been used to produce copies of sophisticated Western ICs for their latest generation of weapons. If the Soviets succeed in acquiring the next generation of materials, equipment, and parts, their military capabilities will continue to improve in the area that is the major strength of the West—quality.

The USSR's practice of reverse-engineering, however, may soon run into problems. As US and Japanese ICs become more complex, reverse-engineering will require: (a) tracking hundreds of thousands of connections; (b) understanding how they all fit together; and (c) mastering the complex processing steps used in production. Thus, copying such circuits will require not only much more sophisticated Western equipment but also much more time to duplicate each circuit, causing their overall microelectronics gap with the West to widen.

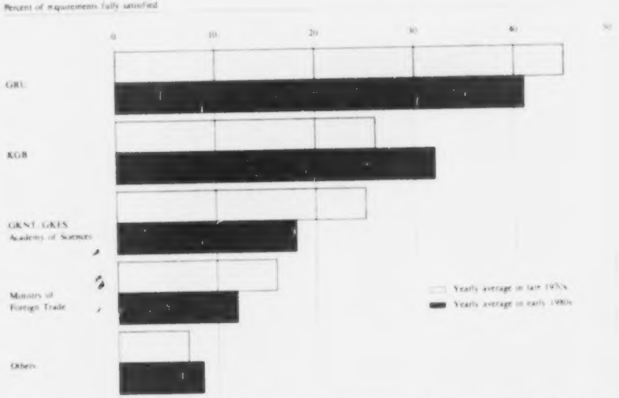
Figure 6
Rank Ordering of Industries by Soviet Military Research Projects Benefiting From Western Technology, Early 1980s



The assimilation of Western technology into Soviet industries conducting military research is considerable. The greatest beneficiaries were the electronics and armor and electro-optics industries, which accounted for over 50 percent (equaling thousands) of all military research projects benefiting from Western technology in the early 1980s.

The general distribution points out the rather broad effect that Western documents and hardware have just on raising the technical levels of Soviet military research. This is particularly true for the top three industries, where advanced technology and innovative design concepts play a significant role in weapon developments.

Figure 7
Soviet Military Requirements Satisfied by Principal Collection Agencies in the Overall VPK Program, Late 1970s and Early 1980s



The distribution shows that the KGB and the GRU (and their surrogates among the East European intelligence services) were the main collectors in the *overall* VPK program. They were involved in satisfying roughly 60 to 70 percent of all VPK requirements completely fulfilled during the late 1970s and early 1980s. (Percentages do not add to 100 because several agencies contributed to fulfilling some of the same requirements.)

Although not evident from the above data, both the KGB and the GRU significantly increased their efforts in the early 1980s because the average *number* of requirements fulfilled so far in the early 1980s (11th Five-Year Plan) increased about 50 percent over the late 1970s.

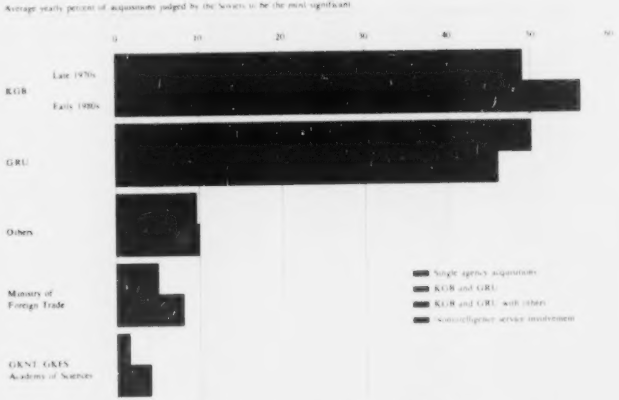
The State Committee for Science and Technology (GKNT) and associated collectors surprisingly were the third main collecting entity, satisfying a relatively large percentage. Figure 8 shows, however, that they were credited with satisfying about 5 percent of a selected subset of acquisitions, those judged by the Soviets to be the most significant to their military research projects.

in many hundreds of military research projects (figure 8). Both the KGB and the GRU levy some of the VPK requirements on surrogates among the East European counterpart services. The KGB probably owes a higher percentage of its collection to these East European civilian intelligence services than does the GRU to its East European counterparts. All use human assets worldwide.

Coordination with the East European services is conducted through the liaison functions at both KGB and GRU headquarters as well as through KGB and GRU advisers in the various Warsaw Pact intelligence services. Since the mid-to-late 1970s the surrogates

Figure 8
Most Significant Acquisitions Satisfied by Principal Collection Agencies, Late 1970s and Early 1980s

The KGB and GRU were involved in collecting about 90 percent of the Western acquisitions judged by the Soviets to be the most beneficial to their military development projects (late 1970s and early 1980s.)



In contrast to figure 7, which shows results for the *overall* VPK program, this figure shows the main collection agencies for a selected subset of acquisitions—those judged by the Soviets to be the most significant to their military research projects for the periods indicated. The Soviet intelligence services and surrogates are the key collectors in the VPK program. Their approximate 90-percent association with the most significant acquisitions (100 percent less the percentages from the categories labeled "nonintelligence service involvement" and nonintelligence "single agency acquisitions") indicates the West has a counterintelligence and industrial security challenge.

About 60 percent of the acquisitions were of US origin (but not necessarily acquired in the United States). The several hundred acquisitions for each period in the statistics above are a small subset of those acquisitions shown in the statistics for the overall VPK program.

among these services have played a major role in the overall VPK collection program, often in return for Soviet economic concessions to their countries. The intelligence services of East Germany, Poland, and Hungary are among the most successful in acquiring Western classified data and export controlled products.

During the late 1970s and early 1980s the GRU probably fulfilled two to 10 times as many VPK requirements as the KGB for the important defense-industrial ministries of:

- Communications Equipment Industry (defense and satellite communications systems)—10 times.
- Machine Building (projectiles and explosives)—five times.
- General Machine Building (strategic missiles and space vehicles)—five times.
- Medium Machine Building (nuclear industry and lasers)—two times.
- Radio Industry (radars and large-scale computers)—two times.

The GRU probably is more successful because of its overall scientific orientation, its bolder operational style, its increased collection opportunities that reflect a wider variety of technology-related cover positions overseas, and its clearer understanding of collection objectives.

The KGB. The First Chief Directorate (foreign intelligence) of the KGB conducts science and technology collection operations through its headquarters component known as Directorate T. Directorate T probably has approximately 1,000 officers, with nearly 300 on foreign assignment. The officers on foreign assignment are organized into components known as Line X, and most of them are scientific specialists by both academic and professional training. The largest KGB complements are probably in Bonn, Cologne, London, New York, Tokyo, and Vienna. (Paris was one of the largest until mass expulsions in 1983.)

Line X officers abroad typically occupy such cover positions as science attaches in a Soviet embassy or equivalent positions in the commercial or economic sections of Soviet missions or an international organization. Other preferred cover positions for these officers are as officials in various Soviet trade missions or as members of scientific or other academic exchanges. Such positions provide easy access to the types of information targeted by the VPK or to foreign personnel who could provide such access. Cover as an "acceptance engineer" at a company with a Soviet contract is also a preferred way to acquire proprietary secrets.

The GRU. The Chief Intelligence Directorate of the Soviet General Staff has emphasized the collection of military scientific data since the earliest days of Soviet military intelligence. Unlike the KGB, the GRU has no headquarters component specifically charged with managing scientific collections; rather, this function is part of the overall responsibilities of four geographic operational directorates. GRU headquarters does, however, have a scientific information analytical directorate that supports scientific collection efforts.

The GRU does not have a separate cadre of career scientific specialists in the field; instead, most GRU officers have technical backgrounds and education as well as years in a military specialization. Approximately 1,500 GRU officers serve outside the USSR. For all of them, scientific collection is an integral part of their responsibilities and a high priority.

The GRU probably has a higher percentage than the KGB of officers with cover positions that provide more access to Western scientific targets and more methods of transporting export controlled products and technical data to the Soviet Union. Some of these positions similar to those of the KGB's scientific specialists are in scientific or commercial sections of Soviet missions or international organizations and various foreign trade offices. In addition, the GRU officers often have positions in Aeroflot (the Soviet airline) and Morflot (the Soviet merchant marine). All Soviet military attaches are GRU officers, of course. The GRU, however, does not seem to use cover positions in academic and technical exchanges to the same extent as does the KGB.

Selected Sources.

US Defense Contractors. Moscow views US and Allied defense contractors with their proprietary and government security controls as difficult targets. Accordingly, the KGB, the GRU, and their surrogates among the East Europeans are the collectors primarily tasked to operate against them. Of the top 100 US defense contractors for 1983, nine of the 10 most frequently cited by the Soviets as sources of needed technology were in the aerospace industry (table 3). The next group most frequently identified was the chemical and petrochemicals industries.

Although the Soviet Bloc intelligence services are the primary collectors of scientific and technological information in the VPK program, it is estimated that about 90 percent of the roughly 100,000 documents acquired each year worldwide are unclassified. About 10 to 20 percent of these unclassified documents are either under proprietary corporate, export, or other government controls. The Soviet intelligence services and their surrogates among the East European services probably provide Moscow with about 10,000 technology-transfer-related classified documents each year from the West. Analysis and operational observations indicate that only a small percentage of these are collected through Soviet intelligence service operations in the United States.

Analysis of hostile intelligence activities indicate that in recent years the surrogates among the East European intelligence services possibly have been more successful than Soviet intelligence against priority defense technologies in the United States. East European services have had considerable success not only in the United States, but elsewhere because:

- They are generally perceived as a lesser threat than the Soviets.
- They often may not be perceived as operating in a surrogate role.
- In some countries, including the United States, they operate under less severe travel restrictions.
- Some, especially the Czechoslovaks and the East Germans, probably find it easier to operate in the West European cultural and commercial climate.

Recent examples of Soviet Bloc espionage operations against US and other Western defense contractor targets are presented in table 4.

As a result of various coproduction arrangements and contract bidding among foreign firms, the availability of much US defense contractor technology overseas in US subsidiaries and in other firms has increased. This enables Soviet Bloc intelligence to seek priority US technologies in many countries around the world.

Commercial Data Bases. Unclassified technical documents from all countries—including engineering analyses and research results—are targeted by Soviet intelligence and other collectors because of their value to Soviet engineers seeking creative designs and alternative engineering approaches. For example, from the mid-1970s to the early 1980s, NASA documents and NASA-funded contractor studies provided the Soviets with their most important source of unclassified material in the aerospace area. Soviet interests in NASA activities focused on virtually all aspects of the space shuttle. Documents acquired dealt with airframe designs (including computer programs on design analysis), materials, flight computer systems, and propulsion systems. This information allowed Soviet military industries to save years of scientific research and testing time as well as millions of rubles as they developed their own very similar space shuttle vehicle.

The individual abstracts or references in government and commercial data bases are unclassified, but some of the information, taken in the aggregate, may reveal sensitive information concerning US strategic capabilities and vulnerabilities. Numerous unclassified US Department of Defense and contractor documents are sought by the Soviets from the Commerce Department's National Technical Information Service. Documents dealing with design, evaluation, and testing of US weapon systems—the Sidewinder air-to-air missile, the F-15, the Redeye shoulder-fired antiaircraft missile, the B-52, and others—are in the data base.

The public and private document clearinghouses—established to efficiently index and disseminate the results of government and government-sponsored military-related technical research—are a fertile ground for KGB, GRU, and other collectors. In recent years, the growing use of electronic data bases has provided the Soviets with an even more efficient means of identifying and procuring such unclassified technical information needed by Soviet designers.

Table 3
Rank Ordering of Top 100 US Defense Contractors of 1983 Compared With Their Rank Ordering by Approximate Frequency of Soviet Identification for Needed Technology, Selected Periods in Late 1970s and Early 1980s

Dollar Value Rank	Company	Soviet Identification Rank	Dollar Value Rank	Company	Soviet Identification Rank
1	General Dynamics	8	40	Soberbio	
2	McDonnell Douglas	5	41	Pan American World Airways	32
3	Rockwell International	4	42	Harris	32
4	General Electric	1	43	Todd Shipyard	
5	Boeing	2	44	Eaton	31
6	Lockheed	3	45	Goodyear Tire & Rubber (Goodyear Aerospace)	17
7	United Technologies (Pratt & Whitney)	11			
8	Tenneco	31	46	Guam Oil & Refining	
9	Hughes Aircraft	15	47	Atlantic Richfield (ARCO)	31
10	Raytheon	23	48	Sanders Assoc	32
11	Grumman	21	49	Waterman Marine	
12	Martin Marietta	7	50	Signal Co (Garrett)	19
13	Litton Industries	20	51	Royal Dutch Shell Group	23
14	Westinghouse Electric	6	52	Motorola	25
15	IBM	19	53	North American Philips (Magnavox)	27
16	LTV	24	54	E Systems	
17	FMC	30	55	Hercules	24
18	RCA	27	56	Morrison Knudsen	
19	TRW	26	57	Mobil	29
20	Sperry	17	58	Ogden	
21	Honeywell	12	59	Morton Thiokol	19
22	Ford Motor (Ford Aerospace)	22	60	Gould	32
23	General Motors	14	61	Congoleum	
24	AT&T	...[a]	62	Caterpillar Tractor	25
25	EXXON	28	63	Emerson Electric	30
26	Northrop	19	64	Control Data	30
27	Allied (Bendix)	9	65	Standard Oil of Indiana	30
28	Maersk Line Ltd		66	Coastal	
29	AVCO	16	67	Penn Central	
30	GTE	32	68	Aerospace	24
31	Textron	32	69	Fairchild Industries	25
32	Singer	23	70	HBH (Hughes Air/Bendix/Holmes)	
33	Texas Instruments	16	71	MIT	13
34	Hughes Helicopters		72	Burroughs	24
35	General Tire & Rubber (Aerojet)	15	73	Pacific Resources	
36	ITT	31	74	Johns Hopkins University	32
37	Standard Oil of California	30	75	Oshkosh Truck	
38	Teledyne	27	76	Gulf Oil	30
39	Motor Oil Hellas		77	Ashland Oil	31

[a] An ellipsis indicates that no targeting for specific technology or hardware was noted during the sampling period to rank these companies; this is not a complete indication that there was no hostile targeting of those companies. Other companies not among the top 100 are known to have been identified by the Soviets for needed technology.

Table 3 (continued)

Dollar Value Rank	Company	Soviet Identification Rank	Dollar Value Rank	Company	Soviet Identification Rank
78	Mitre		90	Gulf States Oil & Refining	18
79	Rolls Royce Ltd	30	91	SAI	
80	Du Pont	10	92	Sunstrand	
81	Williams International	32	93	Kaman	
82	Reynolds Industry	29	94	Kuwait Petroleum	
83	Duchossois Thrall Group (Chamberlain)	29	95	Harsco	
84	NI Industry (Norris)		96	Lear Siegler	30
85	Sam Whan		97	Varian Associates	29
86	Computer Science		98	Southern Union	
87	Xerox		99	Cubic	32
88	Brunswick	30	100	Digital Equipment	29
89	Hewlett Packard	27			

In the VPK program the Soviets issue general guidance to collectors to acquire selected information on, for example, a system (the US Space Shuttle) or a subsystem/technology (electro-optical guidance techniques of the US Maverick or TOW missiles). They follow up this guidance with specific "requirements" and allocate funds for particular pieces of hardware (MK 46 torpedo: more than 1,250,000 rubles (more than $3.5 million), or a U-2 aircraft radio: more than 50,000 rubles), or a document (K-250K-D gyroscope: more than 20,000 rubles), or a dual-use product (excimer laser: more than 20,000 rubles). The government agencies, companies, or contractors that have such information or products are specified. The rank ordering in this table is representative of the number of times a company was specifically identified as a source of needed information and hardware during a selected period. Duplicate numbers beginning with Soviet rank 15 indicate ties in the number of times identified. The data available give a rough indication of large Soviet ongoing needs for innovation in specific aerospace design concepts and hardware as well as for chemical technology and manufacturing equipment.

One solution appears to be to thoroughly screen all candidate data base entries and keep sensitive government information out of the public data bases or limit its availability to US and Allied defense contractors. Unfortunately, this may also inhibit the United States' own national research effort by restricting the ready availability of such information.

Scientific Conferences. Collection of information from professional and academic conferences on applied science and technology has also contributed to the success of the Soviet program. At least 35 conferences worldwide were identified in the VPK program as potential sources of specific data in the late 1970s to assist in solving military research problems. These included conferences on materials, missiles, engines, lasers, computers, marine technology, space, microelectronics, chemical engineering, radars, armaments, and optical communications. The Soviets judged some of the data acquired from these conferences to be among the most significant contributing to their military projects. Conferences in the late 1970s and early 1980s (and Soviet evaluation of the data) ranked in order of significance were the:

- International Radar Conference (improved circuit designs for synthetic aperture satellite radars and aircraft over-the-horizon radars)—Collector: GRU.
- Conference on Integrated Optics (assisted in identifying ways to produce a qualitatively new Soviet category of integrated optical devices for fiber-optics communications)—Collector: KGB.

Table 6
Selected Successful Soviet Bloc Espionage Operations Against US and Other Western Defense Contractor Targets

Agent	Hostile Service	Dates Operated	Access	Impact
William Bell	SB Poland	1978-81	US citizen. Radar specialist, Hughes Aircraft Company. Worked on advanced US radar systems, experimental radar systems, and air-to-air and surface-to-air missiles.	Saved the Soviets several tens of millions of rubles in research efforts; advanced Soviet technology by about five years by permitting them to implement proven design concepts.
Pierre Bourdiol	KGB	1973-83	French engineer.	Currently undergoing trial.
Dieter Gerhardt	GRU	1964-83	South African naval officer who had attended the British Royal Navy College and served at the Embassy in London. Later was a scientific research staff officer.	Passed information on various antiaircraft missiles.
James Harper	SB Poland	1971-81	US citizen. Electronics engineer. Through his girlfriend/wife he had access to Ballistic Missile Defense Advanced Technology Center contracts at Systems Control Inc., California.	Provided dozens of documents on potential US ballistic missile defense programs, ICBM basing modes, and related technology. Afforded Soviets a unique look at potential US future systems concepts.
Manfred Rotsch	KGB	1967-84	West German. Head of the Planning Department of the aviation firm Messerschmitt-Bolkow-Blohm (MBB).	Passed information on the "Tornado" aircraft produced by the European Panavia consortium.

- Conference of the Aerospace and Electronic Systems Society of IEEE (helped technical solutions to existing problems and improved the characteristics of a low-altitude target detection radar)—Collector: KGB.

- International Conference on Radar (assisted development of signal processing for passive jamming suppression methods and for radars to detect distant aircraft targets)—Collector: GRU.

- International Conference on Nontraditional Energy Transformation Systems (refined directions of research on space-based nuclear reactors)—Collector: KGB.

- Conference on Millimetric and Submillimetric Equipment (assisted in design solutions for millimeter wave proximity fuzes)—Collector: KGB.

- Symposium on Solar Energy Conversion (increased efficiency and decreased costs for electron beam deposition of coatings on solar components for space vehicles)—Collector: GRU.

According to Soviet estimates, the information obtained by the KGB and GRU from these conferences alone, particularly the first three, produced savings of millions of rubles in long-range military research projects—savings roughly equivalent to 100 man-years of effort. The fact that numerous professional and scientific conferences are specifically identified as valuable sources in advance by the VPK indicates their exploitation is not fortuitous, but carefully planned.

Ministry of Foreign Trade. The Soviet Ministry of Foreign Trade administers and operates hundreds of foreign trade organizations and firms around the world. This global presence and the ministry's official duties related to technology and transportation make it a practical cover organization for hundreds of KGB and GRU officers involved in technology acquisition efforts. These officers conduct overt and covert collection operations and channel the results through their respective intelligence organizations for accountability in the VPK system.

In addition to providing cover for intelligence officers, the Ministry of Foreign Trade is also a major independent collector in the VPK program and attempts to pursue most of its assigned VPK requirements on an overt basis. During the late 1970s and early 1980s, it helped fulfill about 15 percent of all fully satisfied VPK requirements (figure 7). More important, it fulfilled 9 percent of those satisfied requirements identified as "most critical." Also during that period its role was specialized, focusing largely on the acquisition of microelectronics manufacturing equipment and communications dual-use products. In view of this, it is not surprising that throughout the 10th and thus far in the 11th Five-Year Plans the Ministry of Foreign Trade was assigned to collect the largest percentage of samples (a yearly average of approximately 30 percent) as opposed to documents. The ministry also has a major role in the illegal trade activities discussed later in this report.

Overt and Academic-Related Collectors. The Soviet Academy of Sciences is another collector in the VPK program. So too are the State Committee for Science and Technology (GKNT) and the State Committee for Foreign Economic Relations (GKES). Although these organizations are involved principally in overt collection of information for nondefense industries, they also are involved in worldwide overt collection of information and technical data in response to specific VPK tasking for military research projects. Sometimes they are tasked jointly with the KGB and other collectors to satisfy these requirements.

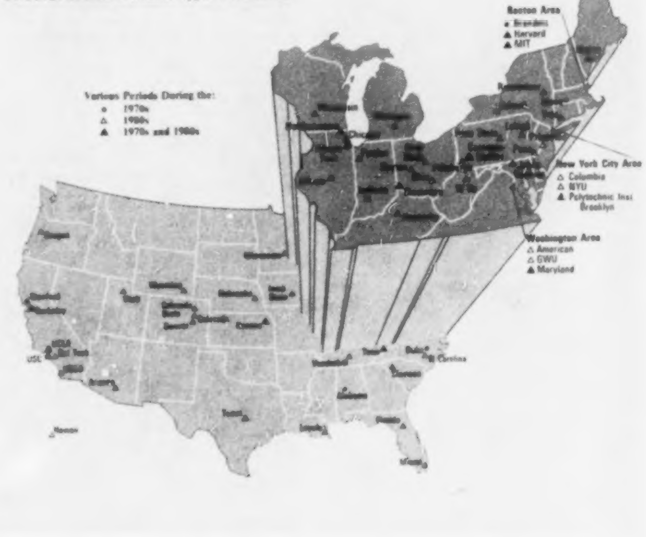
These three collection agencies, especially the Academy of Sciences and the GKNT, operate in the West in a milieu of scientific, academic, and business conferences. They and others help send approximately 2,000 Soviet Bloc citizens to the United States each year in a nontourist status. A portion of those visiting probably respond to high-priority VPK requirements. Additionally, many Soviet scientific personnel have been co-opted to some degree by the Soviet intelligence services to provide assistance to VPK and other collection activities.

During the late 1970s and early 1980s, Soviet scientific collection directives identified numerous universities worldwide that had needed information. Perhaps as a vote of confidence in US academic research, the number of US academic centers targeted has increased from about 20 to over 60 during this period. The universities cited as sources for both applied military-related technology and for civilian scientific data include some of the finest in the United States (figures 9 and 10). The majority of information sought at universities for the VPK program was applied technology and engineering, and not fundamental or basic research.

Carnegie-Mellon, Cincinnati, Kentucky, Massachusetts Institute of Technology (MIT), Michigan, and Wisconsin were among those universities (as well as defense contractors) identified in the VPK program as sources for information on new high-strength, high-temperature alloys, such as titanium, on lightweight structural alloys, and on powder metal processing. California Institute of Technology, Harvard, and MIT were targeted for techniques, methodologies, and results for evaluation of strategic concepts on space, aviation, and missile systems. California Institute of Technology and MIT were also cited as sources for transonic, supersonic, and hypersonic aerodynamic research, as were the Polytechnic Institute of New York (Brooklyn), Princeton, and Stanford. Kansas, MIT, Ohio State, and Penn State were identified for data relating to electrohydraulic control systems applicable to aircraft, helicopters, and the Soviet version of the US Space Shuttle. Research applicable to future high-energy laser and particle beam weapons was sought from MIT, Denver, and Princeton.

As illustrated in figure 7, the three overt and academic-related collectors rank third in the overall VPK program, satisfying about 20 percent of those requirements that were completely fulfilled by all collectors. On the other hand, figure 8 shows that while their overall contribution to Soviet military research collection is large in volume they accounted for about 5 percent of the technology judged most significant by the Soviets during the late 1970s and early 1980s. Acquisitions included information on developing and manufacturing composite materials for missiles and space systems; automated control designs for highly

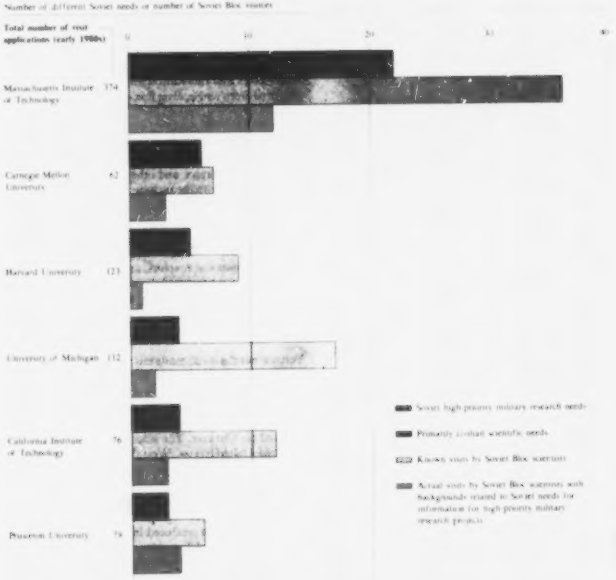
Figure 9
Selected US Universities Identified by the Soviets as Sources of Needed Applied Technology


Various Periods During the:
● 1970s
△ 1980s
▲ 1970s and 1980s
Boston Area
● Brandeis
▲ Harvard
▲ MIT
New York City Area
△ Columbia
△ NYU
▲ Polytechnic Inst Brooklyn
Washington Area
△ American
△ GWU
▲ Maryland
Chicago
USC
Carolina

Over the past decade or so about 40 percent of the US universities shown above were identified in the VPK program as sources of applied science and technology principally for Soviet military aerospace developments. The State Committee for Science and Technology also issues requirements against US universities, but principally for fundamental research for both Soviet military- and civilian-related science developments.

Known Soviet collectors at US and other Western universities include those from the intelligence services, scientists within the Academy of Sciences, and scientists from the State Committee for Science and Technology who come to study in the United States. Many of these collectors are also involved in spotting and assessing US scientists for potential recruitment as agents.

Figure 10
Soviet Needs for Applied Science and Technology From Selected US Universities Compared With Number of Visiting Soviet Bloc Scientists, Early 1980s



The above US universities, as well as Stanford, California at Berkeley, Cornell, and the Illinois Institute of Technology, were identified by the Soviets more often than others during the early 1980s as sources of technology needed for high-priority military and civilian research projects. There is a rough correlation between the number of VPK-identified *military* research needs and the number of visiting Soviet Bloc scientists with backgrounds related to those technical areas. There is, however, little data indicating that specific scientists were tasked to acquire information for Soviet military research projects.

accurate coordinate-measuring machines for quality control of weapon components and subassemblies, information on automatic control systems for optimizing rolling mills; acoustical data for developing low-frequency sonars for submarines; and information on aerial photography, magnetic recording systems, and lasers.

The Trade Diversion Program: Building and Expanding Industries

Numerous sources and data indicate the existence of a program separate and administratively different from the VPK program, but comparable to it in scope. This second program is characterized not by requirements for one-of-a-kind equipment, but by illegal and legal acquisitions of relatively large numbers of dual-use products for Soviet military programs. These products are requested by the defense industries for direct use in manufacturing lines to increase the throughput or output of plants or for designing future equipment. Often manufacturing cells, complete production lines, or even entire plants are sought from the West. Much of this equipment and technology falls into the areas of computers, microelectronics, numerically controlled machine tools, robotics, and material fabrication.

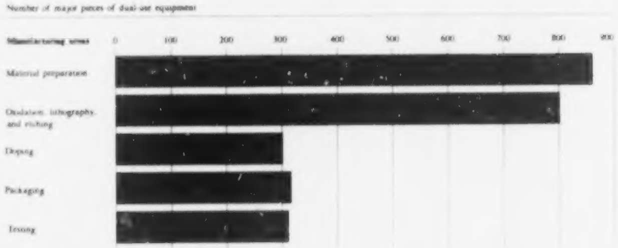
This second Soviet program is probably less structured than that of the VPK, but just as rigidly monitored because of the large amounts of hard currency necessary. This is the Soviet program that appears to be largely responsible for orchestrating and managing most of the worldwide trade diversions, particularly in the areas of computers and microelectronics.

Computers and Microelectronics
Major Soviet diversion efforts are targeted at microelectronics fabrication equipment and computers; nearly half of detected trade diversions fall into these categories. Using unscrupulous Western traders who employ license falsifications, deceptive equipment descriptions, dummy firms, false end users for illegal purchases, and smuggling, as well as assistance from intelligence operations, the USSR has acquired at a minimum several thousand pieces of major microelectronics fabrication equipment during the last 10 years (figure 11). The equipment acquired through these efforts is largely responsible for the significant advances the Soviet microelectronics industry has made thus far, advances that have reduced the overall Western lead in microelectronics from 10 to 12 years in the mid-1970s to four to six years today. Western microelectronics manufacturing equipment has been applied throughout the entire production process—from materials preparation to the final testing apparatus needed for sophisticated production lines. In fact, total design and fabrication lines may have been acquired from single diversion operations.

Volume purchases, legal and illegal, characterize the second Soviet program. Examples of microelectronic products that the Soviets illegally acquired from the United States, Japan, and other countries in one year during the early 1970s include 30 sophisticated crystal pullers, 99 diffusion furnaces, three integrated circuit (IC) testers, and 10 mask aligners. The next year they diverted 24 crystal pullers, 64 diffusion furnaces, three photorepeaters, three pattern generators, three epitaxial reactors, and an IC tester. Such purchases have been used directly in assembly lines for military production. In the future, large quantities of test equipment for sophisticated very-large-scale integrated (VLSI) circuits will be a major target.

Volume purchases of materials are also part of the second program. Before 1980, the Soviets purchased hundreds of tons of electronics-grade silicon (not under export controls at that time). This is the raw material needed for integrated circuits for both military and civilian uses. The silicon originated primarily from the United States, West Germany, and Japan. After the sale of electronics-grade silicon to the USSR was restricted, Soviet acquisitions continued through worldwide diversions. Future acquisitions of silicon very likely will begin to concentrate on the very high-quality silicon produced in the United States, West Germany, and Japan for use in producing VLSI circuits.

Figure 11
Soviet Acquisitions of More Than 2,500 Pieces of Western Microelectronics Manufacturing Equipment, Early 1970s - Early 1980s



Over the past few years the Soviets have virtually completed their entire building construction program for manufacturing military microelectronics components. To equip many of these buildings with advanced production equipment, they acquired more than 2,500 pieces of major Western controlled and uncontrolled microelectronics fabrication equipment covering the entire spectrum of manufacturing operations. They acquired this equipment from the United States, Japan, and Europe, and diverted it through many parts of the world. Years of illegal acquisitions of large numbers of dual-use products through worldwide trade diversions have enabled the Soviets to narrow the microelectronics technological gap with the West from 10 to 12 years a decade ago to about four to six years today.

Integrated circuits intended for direct use in Soviet systems are usually acquired from the United States and Japan by trading companies in various parts of the world, and then shipped in huge numbers to Soviet and East European destinations. As many as 100 million circuits may be shipped in this manner every year.

In direct monetary value, volume acquisitions through illegal trade probably far exceed those of the VPK-directed effort. The Soviets have diverted thousands of different items of high technology in the past two decades, totaling perhaps billions of dollars in hardware value alone. Most of these illegal acquisitions have been facilitated or conducted autonomously by unscrupulous traders. The manufacturers of high-technology production equipment have rarely been knowingly involved in diversions; indeed, they have often been victims.

The Soviets have arranged most diversions through Europe, but their use of Asia as a diversion route is growing. Over 300 firms in more than 30 countries have been identified as engaged in diversions. Many more companies probably exist—some involved in only a few operations and quitting or disbanding before becoming well known or vulnerable.

Participants in the Second Program
The Soviet intelligence services and the Ministry of Foreign Trade are involved in various ways with most of this illegal trade, some of which is conducted through ostensibly normal trade channels. The Ministry of Foreign Trade and industrial ministries operate a large network of foreign trade organizations, commercial offices, joint companies, and foreign procurement offices whose staffs know the hardware markets

and act as ready contacts for technology traders and diverters who may volunteer their services to the Soviets. They are also quite adept at spotting opportunities for diversions and obtaining controlled Western products. These functions are performed by legitimate Soviet trade officials, intelligence officers under trade cover, and trade officials working directly for intelligence officers. Many of the 141 Soviets expelled from 25 countries during 1983 were assigned in some capacity with the Ministry of Foreign Trade.

The Soviet illegal trade program appears to be administered and managed in the trade ministry's Main Engineering and Technical Administration (GITU). Although it is a component of the ministry, GITU is staffed and managed largely by intelligence officers, organized into separate KGB and GRU groups by their respective headquarters. Its subordinate Department for Technical Cooperation with Foreign Countries is similarly staffed and managed. GITU reportedly exercises some supervision over all technical Soviet foreign trade organizations and all technical joint trading companies.

The GITU staff has grown from about 12 in 1970 to about 70 in 1983. Its subordinate Department for Technical Cooperation with Foreign Countries numbers over a hundred. The intelligence officers assigned to GITU, and to the Ministry of Foreign Trade in general, blend into a number of roles in carrying out their assignments. Soviet intelligence service personnel (as well as their East European surrogates) are in embassy commercial sections, trade missions, consulates, commercial organizations, and joint stock companies in the West. Moreover, intelligence officers have been identified as employees of foreign trade organizations in the Soviet Union and their offices elsewhere in the world.

Although GITU is largely a Soviet intelligence service domain (with the GRU probably filling most cover positions), that does not mean that all trade diversion operations are conceived of and supervised on a daily basis by intelligence officers. Some evidence indicates that the GRU is involved with more trade diversion operations than the KGB, but it is unknown if this is by design or rather a practical manifestation of the high proportion of foreign-trade-related GRU cover positions. Legitimate Soviet trade officers in Warsaw Pact countries are also involved in trade diversions, and not merely as intelligence co-optees.

Use of Diverters-for-Hire
One of the most effective and secure trade diversion methods used by the Soviets is the contract or broker diverter. Contractor diverters work for set or negotiated fees; broker diverters receive a commission, usually a percentage of the equipment purchase price. Both are individual traders or businessmen with some affiliation to high-technology manufacturing or trade circles. They are very knowledgeable of high-technology markets and product availability and either volunteer their services to the Soviets or are spotted by Soviet assets in the West or in the USSR. Some have global expertise and connections; some specialize in operations in a few countries or a few technology product lines. In some cases, the Soviets have used diverters with known track records of trading almost exclusively, or in high volume, with the East Europeans.

Whether a volunteer or selected by the Soviets, a potential contract or broker diverter is generally screened to determine the scope and depth of his contacts, range of trade abilities, and access to pertinent high-technology markets and manufacturers. In some cases such an assessment may be a rigorous one, in others perhaps only superficial. A most important quality, however, is the ability to deliver goods as scheduled, for close to the agreed prices, without complications or risks to the Soviet customer.

Although many Soviet intelligence officers are involved with negotiating and contracting with diverters, this procedure is not a classic intelligence operation and is analagous to an intelligence "recruitment" in timing only. The diverter does not accept intelligence discipline as would an "agent." Indeed it makes little or no difference to diverters if they are dealing with intelligence principals as opposed to trade officials, save for the need to avoid the suspicions of espionage. Additionally, most diverters probably do not enter into a permanent relationship with their Soviet principals, but rather into one that is only for the duration of one or a series of formal or informal contracts for specific products or services.

Although there are dissimilarities among contract or broker diversion operations, there are some characteristics that seem consistent:

- The Soviets incur minimal, if any, risk or legal liability. Many, if not most, contracts are scheduled, briefed, signed, or verbally agreed to in Moscow or another convenient denied area or are obscured by the conduct of legitimate overt business.

- Little or no contact is maintained with the diverter. This seems especially true of diverters operating on behalf of a Soviet intelligence service.

- For the most part, the diverter has autonomy in operational decisions, including arranging front organizations, product availability, purchase, shipping, storage, and delivery. At times diverters also perform initial professional setup, testing, and servicing of equipment. In so doing they rely exclusively on professional overt and covert colleagues.

- Fees are negotiable. The Soviets will pay lucrative, but not outrageous prices. Fees can also be raised during the course of the diversion if more costs or risks are entailed by the diverter.

- Payment is generally through letter of credit deposited by the Soviets to the diverter's bank account.

The use of contract or broker trade diverter operations by the Soviets minimizes, if not obviates, the risk to their intelligence residences and trade officials while simultaneously assuring the application of professional business and trade diversion know-how to the technology acquisition task. Because of the low Soviet profile in these operations, more vigorous law and trade control enforcement may be more effective in stemming contract diversion than counterintelligence responses, although both efforts clearly have an important role.

Contract Trade Diverter: Richard Mueller

Richard Mueller, a West German citizen, is wanted in that country and in the United States for many cases involving illegal exports of COCOM-controlled computers, microelectronics, and other products to the USSR. His involvement with illegal technology acquisition on behalf of the Soviet Bloc dates back to the early 1970s. By 1978 Mueller's deals were made almost exclusively with Soviet foreign trade officials; some of these officials were intelligence officers under cover. For his network, Mueller uses numerous dummy and front firms and meets with his Soviet principals in Moscow to mask his activities. At one time he had more than 75 firms operating in Austria, France, Switzerland, the United Kingdom, the United States, and West Germany.

Between 1978 and 1983 Mueller delivered to the Soviets advanced computers, peripherals, and microelectronics manufacturing equipment worth at least several tens of millions of dollars. Perhaps Mueller's best known operation was his attempted diversion to the USSR in late 1983 of seven large US Digital Equipment Corporation VAX computers and related hardware and software. The VAX series of super minicomputers are valuable to the Soviets because of their computer-aided design (CAD) applications for microelectronics fabrication. This equipment was purchased in the United States for Mueller's dummy firms in South Africa and West Germany. Much of it was seized by Sweden and West Germany enroute to the Soviet Union.

Other Diversion Methods
Soviet foreign trade officers also attempt to make small Western firms dependent on Soviet legal orders over a period of years. For such firms, who are not contract or broker trade diverters, the occasional

Soviet request for illegal purchases or a support role in a larger illegal trade operation appears difficult if not impossible to refuse. Indeed, some firms may even be drawn into complicity or support for Soviet diversion operations unwittingly or gradually. It has long been a concern in the West to limit the expansion of Soviet foreign trade organizations abroad because of the opportunities they offer for this type of diversion activity. Although it has become more difficult for the Soviets to conduct this type of activity, Moscow continues to keep these diversion channels open.

The Soviets also acquire technology to modernize manufacturing through another mechanism, the so-called acceptance engineers. They are assigned as quality inspectors on a long-term basis, usually a year or longer, to Western firms engaged in manufacturing items for Soviet end users. These may be intelligence officers or Soviet personnel who are co-opted to steal proprietary production or technical data. They also use this opportunity for agent spotting for immediate or future exploitation. Use of acceptance engineers for collection is especially practical in countries with advanced manufacturing technology. Companies in Western Europe and in Japan have been targeted with this approach.

Prospects for Stemming Losses

The West needs to better organize to protect its military, industrial, commercial, and scientific communities, keeping two objectives clearly in view:

- First, it must seek to maintain its technological lead over the Soviets in vital design and manufacturing know-how.

- Second, it should strictly control key dual-use products, including computer-aided design and manufacturing systems, large volumes of automatic test and inspection equipment, and, most important, the automatic test equipment that can alleviate acute Soviet qualitative deficiencies in the manufacturing of weapons and military equipment.

The ultimate goal should be to deny the Soviets access to Western documents, hardware, and technologies that will accelerate their military programs and simultaneously cause Western defense efforts and costs to increase. Soviet dependence on the West for technological innovation in military research and development and in modernizing Soviet production industries is broad. It is particularly important in microelectronics and computers, and extends to key areas that include command, control, communications, and intelligence (C^3I), computer-integrated design and manufacturing, and materials fabrication (table 5).

The United States and many other Western governments have begun to better recognize that their military and dual-use equipment and technologies have been improving the performance capabilities and manufacturing standards of Soviet weapons. Several positive steps have already been taken by the United States, Western Europe, and Japan, including selective expansion of the COCOM [1] list to deny the Soviets key items. Although the emphasis has varied among countries, most have undertaken individual programs to stem diversions and losses that include some of the following:

- Increased awareness programs, highlighting the magnitude, tactics, and detriment to Western security of the Soviet efforts.
- Improved export control efforts and enhanced law enforcement capabilities.
- Counterintelligence programs specifically targeting the technology transfer activities of hostile intelligence services and their Soviet co-optees and agents.
- Industrial security awareness programs conducted jointly by counterintelligence services, security services, and corporate security professionals.
- Soviet Bloc scientific visitor controls designed to screen high security risk visitors and, in the process, strengthen the spirit and integrity of academic exchanges.
- Better review of government open publications in the prepublication or predistribution phases.

In general, a more difficult operational environment for Soviet intelligence has resulted worldwide.

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[1] The Coordinating Committee (COCOM) was established in 1949 to serve as the forum for Western efforts to develop a system of strategic export controls. It is composed of the United States, the United Kingdom, Turkey, Portugal, Norway, the Netherlands, Luxembourg, Japan, Italy, Greece, France, the Federal Republic of Germany, Denmark, Canada, and Belgium.

Table 5
Examples of Dual-Use Equipment and Technology Likely To Be Targeted by the Soviets

Microelectronics

- Advanced Integrated Circuits
  - GaAs Devices
  - Memories
  - Microprocessors and Peripherals
  - Very-High-Speed Integrated Circuit (VHSIC) Devices
- Automatic Integrated Circuit and Printed Circuit Board Testers
- Chemical Vapor Deposition (CVD) Equipment, Especially Metal-Organic CVD Systems
- Computer-Aided Design (CAD) Systems
- Integrated Optics
- Ion-Beam and Plasma Etchers
- Ion-Implantation Equipment
- Lithography Equipment, Especially Electron-beam, Ion-beam, and X-ray Systems
- Molecular Beam Epitaxy (MBE) Systems
- Semiconductors
  - III-V and II-VI Compounds
  - Heteroepitaxial Materials
  - Specialized Crystal Pullers
  - Quality Silicon for Very-Large-Scale Integrated (VLSI) Circuits

Computers

- Array-Transform Processors
- Artificial Intelligence Systems
- Data Display Equipment
- High-Density Disk Storage Systems
- Internal Memories
- Software Development Systems
- Stand-Alone Mainframe Computers
- Supercomputers
- Superminicomputers

Command, Control, Communications, and Intelligence (C^3I)

- C^3I Software
- Computer Networking Systems
- Telecommunications
  - Fiber-Optics Transmission Systems
  - Digital Switching Systems
  - High-Speed Modems
  - Satellite-Communications Systems
  - Terminal Displays

Computer-Integrated Design and Manufacturing

- Computer-Aided Design Software, Methods, and Equipment
- Computer-Aided Manufacturing (CAM) Software
- Computer Numerical Controls for Metalworking Machines
- Coordinate Measuring Machines
- Finite Element Analysis
- Flexible Manufacturing Systems (FMS)
- Plant Control Software
- Robotics

Material Fabrication

- Metals and Alloys
- Composites
  - High-Strength Fibers and Filaments
  - Carbon-Carbon Manufacturing
- Ceramics
- Materials Processing
  - High Temperature Resistant Coatings
  - Isostatic Presses
  - Lasers for Surface Conditioning and Material Processing
  - Material Joining and Bonding Equipment
  - Nondestructive Test and Evaluation Equipment
  - Precision Shapers and Formers
  - Vacuum Furnaces, Including Those for Single Crystal Growth

The worldwide diffusion of advanced products and high technology, however, clearly has increased Soviet collection opportunities. To take advantage of this, the Soviets can be expected to intensify operational acquisition efforts by:

- Expanding their use of contract diverters on a global basis.
- Increasing their dependence on surrogates among the East European intelligence services; increasing use of client states such as Libya, Vietnam, and North Korea.
- Increasing their exploitation of any vulnerable US and Western defense weapon system coproduction arrangements in Allied countries.
- Relying more on third-country espionage operations targeting US personnel and technology (mostly handling covert assets in areas outside the United States).
- Exploiting Third World trade entities dealing with US high technology (the Soviets contend that corporations, officials, and security services in those countries can be easily victimized).

- Attempting broader online access to US and other Western data base systems directly from the Soviet Union.

For effective countermeasures to keep pace with the evolving Soviet acquisition programs, in particular the highly effective operations of the KGB, the GRU, their surrogates among the East Europeans as well as unscrupulous traders, the West should accurately anticipate Soviet tactics. Western countries should continue to improve and modify their responses. In particular, the West needs to improve and refine its knowledge of Soviet military-technical needs and factor this knowledge into meaningful and practical, multilateral export control lists. Most important, however, must be increased multinational coordination of Western programs—for example, a systematic program among the Western customs services aimed at preventing the illegal export and diversion of militarily significant equipment in the face of what clearly will be a geographically expanding Soviet acquisition threat.

Much can be done to stem losses because much is known about Soviet efforts; it is not an insurmountable problem. But the Soviets' appetite for Western technology will continue to be voracious. They will continue to exploit any weaknesses in Western export controls, as well as policy differences among the COCOM countries, to acquire the technologies needed by their military programs for the late 1980s and beyond.

This effort is more difficult and costly for them than at any time in the past. The stakes are high and the Soviets know it; they will devote whatever resources and manpower are required to fulfill their most critical military collection requirements. The West can do no less if it is to succeed in protecting itself as well as frustrating their efforts. All in the West—governments and private industries—will need to participate.

Annex

Several Hundred Examples of Soviet Military Equipment and Weapons Benefiting From Western Technology and Products

There are hundreds of examples of Soviet military equipment and weapons of the 1980s and 1990s that have benefited or will benefit from the technologies and products of at least a dozen different Western countries. New and advanced technical directions will be incorporated into some of the weapon systems, subsystems, and equipment in each industrial area given below. The equipment in many projects will have their technical levels raised or project completion dates shortened principally because of the copying of design concepts embodied in Western technical documents, one-of-a-kind military hardware, and dual-use products.

Aviation

- Four New Fighter Aircraft
- New Tactical Fighter of the 1990s
- A Supersonic Aircraft
- Ground Attack Aircraft
- Airborne Command Post
- Reduced-Infrared-Signature Aircraft
- Four Transport Aircraft
- Reusable Space Shuttle
- Air-to-Air Missile (US Phoenix-Like)
- Fire-Control System for Three Fighters
- Gas Turbine Engine
- Ramjet Engine

Projectiles and Explosives

- 100-mm and 152-mm High-Explosive Shells
- 203-mm Artillery Shell
- Sabot Design for Armor-Piercing Tank Round
- Armor-Piercing Tungsten Penetrator Shell
- 23-mm Gun
- Aviation Cluster Bomb
- Remote Mining Shell Delivered by Artillery, Rockets, and Aircraft
- Large Caliber Artillery Shell Casing
- Small Caliber Ammunitions
- Noise-Detonated Fuze
- Microelectronic Radio Fuze
- Millimeter-Wave Proximity Fuze
- High-Efficiency Proximity Fuze for Mass Munitions
- Antisubmarine Torpedo
- Antisubmarine Missile
- Munitions Testing Equipment
- Thermal Decoy Target
- Protective Blast Structure
- Solid Propellant
- Unmanned Target Plane Equipment

Armor and Electro-Optics

- Space-Based Photoreconnaissance System
- Infrared Space Reconnaissance System
- Space-Based Missile Launch Detection System
- Space-Based Infrared Image Processor
- Synthetic Aperture Radar for Space Reconnaissance
- T-55 Tank
- T-64 Tank
- T-64A Tank
- T-64B Tank
- T-72 Tank
- T-80 Tank
- 125-mm Tank Gun
- Industrial Gas Laser

- Aerial Frame Camera
- High-Altitude Aerial Camera
- Coordinate Measuring Machine
- Portable Antiaircraft Missile System
- Advanced Night Vision Device
- Small-Arms Night Sight
- Holographic Fire-Control System
- Laser-Guided Artillery Shell
- Laser Gyro
- Optical Computer for Tactical Ballistic Missile
- Diamond Turning Device for Mirrors for Future Laser Weapons
- Laser Rangefinder
- Antitank Missile
- Countermeasure Against US Antitank Guided Missile
- Automatic Gun Barrel
- New Artillery Gun Barrel
- Sniper Rifle and Machinegun
- High-Strength Gun Barrel from Electroslag Steel
- Automated Rolling Mill for Military Production

Missiles and Space

- A New ICBM
- A New SLBM
- Maneuvering Reentry Vehicle (MaRV)
- Strategic Cruise Missile
- Reusable Space System (Shuttle)
- Navigation Satellites
- Manned Space-Based Orbital Station
- Reentry Vehicle
- Carbon-Carbon Nosecone for Reentry Vehicle
- Missile Motor Case Material (Based on DuPont Kevlar 49)
- Surface-to-Air Missile
- Missile Fuel Tank
- Cryptographic System
- Telemetry System

Communications

- Aircraft-to-Submarine Communications System
- High-Altitude Video Reconnaissance System
- Video Processor for Space Reconnaissance
- Reconnaissance Radio Receiver
- Strategic Aircraft and Cruise Missile Communication System
- Fiber-Optics Communications System
- Electronic Countermeasure Station
- Signals Intelligence Equipment
- Narrow-Band Signal Analyzer
- Cryptographic System Scrambler
- Magnetic Recorder
- Fiber-Optical Cable
- Microcomputer for Communications
- Programmable Oscilloscope
- Digital Processor
- Printed Circuit Board Production Equipment for Communications
- Correctable Aerial Bomb
- Remotely Piloted Vehicle
- Electronic Page Teleprinter

Radars and Computers

- ABM Radar System Design
- Space-Based Oceanographic Radar
- Three-Dimensional Phased-Array Radar
- Over-the-Horizon Radar
- Shortwave-Band Aircraft Radar
- High-Capacity Computer
- Disk Drives for Ryad Computer
- Computer Software
- BESM-6 Computer
- Magnetic-Bubble Computer for Onboard Missile
- Computer Matrix Processor

Nuclear and High-Energy Lasers

- Nuclear Weapons Safety System
- Space-Based Nuclear Reactor
- Nuclear Reactors
- Naval Nuclear Reactor
- Water-Cooled Power Reactor
- Process for Reactor-Grade Zirconium
- High-Sensitivity Mass Spectrometer for Uranium Enrichment
- Isotope Separation Process
- Space-Based Microprocessor for a Detector
- Radiation Detector
- Airborne Military High-Power Carbon Dioxide (CO_2) and Carbon Monoxide (CO) Laser Weapon
- High-Power Gas Dynamic Laser
- Space-Based High-Energy Chemical Laser Weapon

Shipbuilding

- New Aircraft Carrier Catapults for High-Performance Airplanes
- New Submarine
- Submarine Quieting Equipment and Techniques
- Antisubmarine Torpedo
- Telecontrolled Torpedo
- Torpedo Missile
- Laser Submarine Wake-Detection System
- Radioactive Submarine Wake-Detection System
- Hydrophone for Aircraft-to-Submarine Communications
- Magnetometer
- Surface Warship
- Warship-Based Multitarget Radar Fire-Control System
- Sonar System for Nuclear Submarine
- Sonar for Surface Ship
- Sonar for Ships and Helicopters
- Sonobuoy
- Radiowave Underwater Communication System for Diver-Scouts
- Ship Demagnetizer
- Gyrohorizoncompass for Naval Ships
- Naval Gun

Electronics and Microelectronics

- Photolithography System
- Photomask Equipment
- Microelectronics Tester (Fairchild Corporation SENTRY-7 Design)
- LSI IC Circuit Mask Fabricator
- Microelectronics for Onboard Weapon Systems
- Large-Scale Integrated Circuit Tester
- Microprocessor (Motorola MC 10800 Series Design)
- 16-Bit Microcomputer
- Computers (Digital Equipment Corporation PDP Series Design)
- Micro- and Mini-computers for Military Purposes (AM 2900, LSI-11M, PDP 11/70 and REDAC Designs and Hardware)
- Memories for Onboard Radar Fire Control Systems
- Computer Memories
- New Semiconductor Thyristor for Military Equipment
- Charge Coupled Devices
- Traveling Wave Tube for Military Satellite Communications
- Space-Based Laser Communication System
- High-Power Microwave Tube for Onboard Radar Against Low-Flying Targets
- Laser Communication, Detection, and Ranging System (Hughes Aircraft Company 3800 Design)
- Infrared TV System
- MIG Aircraft Centimeter Waveband Radar with Onboard Digital Processing
- Compact Analog-Digital Converter
- Quartz Resonator
- Crystal Grower
- Power Generator
- Communication and Telemetry System
- Microwave Generator

Chemicals

- Hybrid Ramjet Engine for Cruise Missile
- Solid Rocket Propellant for Strategic Missile
- Polyethylene Production System
- Color Aerial Photographic Film
- Photographic Film for Air and Space Reconnaissance
- Photographic Film for Space Reconnaissance (Kodak 3414 Film)
- Antistatic Photoreconnaissance Film
- Low-Density Polyethylene
- Photoresist System for Microelectronic Photolithography
- Polyamide Composite Materials for Aircraft and Tank Industries
- Carbon Fiber Production for Aerospace Applications
- Radiation Hardening Paint for Radioelectronic Equipment
- Bonding Material for Spacecraft
- Ion-Exchange Resins
- Laser Systems for Remote Chemical/Biological Reconnaissance
- Fillers for Deep Sea Vehicles
- New Gas Mask

Electrical Equipment

- Space-Based Turbogenerator
- Tank-Mounted Infrared System
- Sodium-Sulfur Battery for Missiles, Space, Tanks, and Submarines
- Electric Step-Motors for Aviation Weapon Systems
- Power Sources for Missile Installations
- Space-Based Solar Power Cells
- Spacecraft Temperature Control System
- Ship Electrical Supply System
- Batteries for Naval Ships

Petroleum and Petrochemicals

- New Fuel for Strategic Cruise Missiles
- New Jet Engine Fuel
- Polyurethane Binders for Solid Rocket Fuels
- New Zeolite Catalyst for Motor Fuels
- Synthetic Motor Oil for Tanks in Arctic Areas (Mobil Oil Company)
- Synthetic Lubricant for Aerospace Equipment
- Radiation-Resistant Additives to Lubricants for Space
- New Lubricant-Coolant for Motor Vehicles
- Rubberized Fabric Inflated Seal for Supersonic Military Aircraft
- Industrial Rubber for Aerospace and Armored Vehicles
- Industrial Rubber Seals
- High- and Low-Temperature Fluoroelastomer for Aerospace and Armored Vehicles
- Improved Protective Gear for Astronauts and Pilots
- Radar-Absorbing Camouflage Coating

The CHAIRMAN. Mr. Allen, many have suggested that this authority to give the President the opportunity to control loans to Soviet bloc countries at this time would be a slap at the Soviet Union. We are approaching a summit and obviously we are not supposed to do anything to upset the applecart. We're not supposed to say anything naughty about the Soviet Union. We're supposed to be quiet and so on.

Do you think that's a valid argument for not continuing with this process in the Congress?

Mr. ALLEN. Well, Senator, not only do I not think it's a valid argument, I don't think—in this context, I don't think it's valid in its own right.

NEED TO DEFEND U.S. INTERESTS TRUTHFULLY AND FORCEFULLY

The failure of the United States to defend its interests and to speak truthfully and forcefully about the Soviet Union is not something that's going to advance our national interests and enhance our security.

I believe that the consideration of important legislation like this must indeed continue without regard to the extraneous considerations of what the atmosphere may be in the run up to the summit.

I have supported the notion of the summit and I have done so publicly and privately for more than a year. My view is that this summit is not designed to resolve any specific problems but it is indeed to be a get-acquainted summit and one that can make a major contribution perhaps by laying out an agenda for further negotiation at the ministerial level or perhaps even for further summit conferences.

But the notion that we should somehow restrict valid, legitimate and necessary criticism at a time like this strikes me as preposterous, if not pusillanimous.

The CHAIRMAN. Well, I would agree. I think it is absolutely ridiculous that the Soviets can say anything they want about us, but we're not supposed to say anything bad about them because it may cause repercussions. I don't think it really makes that much difference to them what is or is not said here in the Senate Banking Committee. They will go ahead with their agenda regardless. I suppose they would prefer that we not say things just so they have even less difficulty going ahead, but I can't accept that as a valid argument any more than I've accepted it for the last 11 years by the apologists for the Soviet Union who continue to take that line, that we're supposed to be nice, turn the other cheek, be blamed for every bad thing that goes on in the whole world, while they continue merrily along their way, raping our country through technological transfers, stealing, theft, legal means, the whole spectrum. So it's an argument that I completely reject.

The Polish debt crisis was approaching its climax during the time that you were the President's National Security Adviser. What effect do you think it may have—and I realize this is speculation and it's hindsight but hindsight is often very good, at least most everybody thinks it is—what effect do you think it might have had if the President had had this type of authority prior to the Polish debt crisis? Do you think it would have made any difference?

Mr. **Allen**. I think it certainly would have made a difference had it been exercised in the pursuit of broad policy objectives. I think that this authority in the hands of the President is something that should not be used just sporadically or spasmodically, but should be used cleverly in pursuit of those broad objectives which should be to try to shape, if in fact it is possible to shape, the behavior of the Eastern nations.

At the time, in 1981, I favored declaring the Polish loans in default. That position was not adopted. Many felt that this would set in motion a catastrophic chain of consequences and I have to admit that I was very much moved by the arguments that the impact of default would be visited upon the Polish people. They're a sturdy and durable people and they have demostrated their devotion to principle and to democracy in their resistance to the Soviet Union. I don't believe that mass starvation would have occurred. It might have been a useful clarifying device.

The part that interests me that is implicit in your question, Mr. Chairman, is that we never seem to learn. I mentioned that for nearly 30 years I've been a student of the Soviet Union, of East-West relations, and I've seen the cycle come and go and the Soviets, in my view, are now sensing another cycle of the fatted calf, in that they view the prospect of a potential thaw either as a result of the summit itself or in the decisions coming in the months that would follow it, an opportunity to tap once again legally and openly into a dose of Western technology, so to speak, to get a fix.

It is true that we lead the Soviet Union technologically. It's also true that we trail the Soviet Union in most measurable categories of military equipment and military significance. The Soviet Union does pursue a doctrine of adequacy in terms of its military capabilities.

EASTERN BLOC IS CONDUIT TO THE SOVIET UNION

To the extent that we loan to Eastern European countries who are in fact nothing but transmission belts or conduits to the Soviet Union, to that same extent we make easier the Soviet challenge of continuing to maintain military superiority over the United States and to that same extent we invite the prospect of allowing our own technology, as you suggested, Mr. Chairman, to be turned against us.

This is a frightful situation. It's not the first time it's happened. Now, 22 years ago this committee, then under different auspices, in November conducted a series of hearings into what was then a revolutionary consideration—providing credits to the Soviet Union for grain purchases. I went back through the hearings not long ago and refreshed my memory and found that the same arguments were used in 1962. Indeed, they were used in 1960 and the 1950's when the discussions of East-West trade came up.

It was during this period of the 1960's and the 1970's when the doctrine or the full flower of détente I guess you might say reigned supreme in this country.

Now everyone has to be for détente. Détente simply means relaxation of tensions and it should be the basis of every nation's foreign policy.

But the doctrine of détente or the policy of détente as we knew it in the 1970's was rather elaborate. As I suggested, it had its roots in the 1960's just after the Cuban missile crisis. The doctrine held that if we were able to engage the Soviet Union in an intricate web of economic agreements that involved the provision of technology and credits, know-how and what-not to the Soviet Union, so that the Soviet Union might improve the domestic side of its economy, if we globalized, so to speak, the Soviet Union in this fashion, we would then be able to declare, as we did often, that détente is not divisible, meaning that the Soviet Union would not be able to continue to receive the benefit of this flow of technology and credit and, if you will, goodies, in the broad sense of the term, and at the same time behave atrociously in the Third World.

Well, of course, the Soviet Union demonstrated that it did consider détente divisible and demonstrated that détente could be divided and continued to reap the benefits of this enormous flow of technology from the West as bankers and industrialists were racing to Moscow to tap that great market of 235 million people and presumably its great consumer purchasing power.

It ended in failure. In the early 1980's, thanks to the attention of men like yourself and President Reagan, we began to get a handle on this.

What you are proposing today is just another step in this process. I sense in the way the Congress and the Senate and this committee is approaching this issue today that now as never before we have this matter clearly in focus and it's time to give the President this next dose of authority so that he can conduct our affairs more intelligently in the long run.

The **Chairman**. Your comment about cycles is so correct, because if you look back and review the past and you look at the horror of the world back in the days of the Russian imposition in Czechoslovakia and in Hungary and how upset everybody was, if you look more recently at Afghanistan, if you look at the uproar over the KAL–007, it should be clear to anybody that has half a brain that they want to play the détente game, take advantage of all of the positive things for them, and have incidents of that kind—invading countries, continual subjugation, recognizing that it won't be too many months until we have forgotten—it gets off the headlines and then we go back to business as usual.

That is an overwhelming pattern that should be so clear to everyone, and it will happen again. We're back in the time where we're supposed to be nice. They will be. I wouldn't expect any large international incidents for a while until they get another chunk of us and then there will be another Afghanistan and we will all be mad and we'll all have these editorials and then we'll say, "But we've got to resume détente; we've got to be nice again."

I don't know how many years or decades it goes on until we learn how much they gain during those periods of détente and yet recognize that the criticism will only be relatively brief.

I'd like to have the American press follow the daily activities of the Soviet Union in Afghanistan as they did the activities in Vietnam. It might be very enlightening. Or their activities in many other areas of the world—Nicaragua, Cuba, Africa, South Africa, so on. I wish we could get that kind of coverage about their abuse of détente, but I suppose that's a little bit too much to ask.

Let me just ask you one more question. My time is up on this round.

United States banks really got out of making new loans to the Soviet bloc countries at the time of the Polish debt crisis. Do you know of any developments since that time that have changed either economically or militarily? Is there any reason why those loans should be resumed? What's different now than when they got out of making those loans 3 or 4 years ago?

Mr. ALLEN. Mr. Chairman, I see no difference in circumstances whatsoever. There is perhaps some explanation in the actions of the Federal Republic of Germany. I happen to be quite familiar with the loan credit process that was arranged for East Germany by the Federal Republic and it was largely through the efforts of the Prime Minister of Bavaria, Franz Joseph Strauss.

IMPORTANT CONDITIONS ATTACHED TO CREDITS

It's interesting that attached to these credits were some very important conditions, not the least of which was the dismantling of some of the elements of the death strip between East Germany and West Germany, and certain other conditions that are in the process actually of being fulfilled by the East Germans that will alleviate the plight of the people in East Germany and will make easier the reunification of families to travel and visit. This was farsighted. I spent many hours in initial criticism, heated criticism, with my friend, Prime Minister Strauss, on this issue and learned what was behind his thinking and his actions that made the credits ultimately possible, and it could be that in the case of East Germany that Western banks, U.S. banks particularly, find themselves again competing with the Western Europeans.

But they compete without a purpose. Our banks claim that there is no political linkage, that they are essentially apolitical or unpolitical. That must mean that they are astrategic or unstrategic and nonstrategic as well. They claim that, as I pointed out and you have too, that their actions bear no relationship to the long-term security of the United States. This is patently false.

The President has made this point. Secretary Weinberger has made this point. This is not, as we've observed, the first cycle of alarm on this vital issue. The only way I know how to deal with something like this is to hold a hearing such as the one you're having today and to invite those people to come and defend their actions, to defend their apolitical stance or astrategic stance, if you will, toward the Eastern European countries.

There is nothing in the record of nearly seven decades of dealing with the Soviet Union that justifies this notion.

If I may just for a moment allude to a still earlier period, Senator Garn, when the Bolsheviks took power in 1917, they immediately tried to implement the principles of communism. There ensued a period of about 3 years, lasting until 1921, called the period of real communism. It was a crazy period. All sorts of things were tried in the Soviet Union and the economy went into a virtual state of collapse. You recall that what was then Imperial Russia had shrunk to the size of basically ancient Moscovy. The Ukraine was lost temporarily and other peripheral areas had to be given up by the Bolshevik leadership.

In 1921, Lenin suddenly changed course and announced something called the new economic policy. This period lasted until about 1927. Lenin died in 1924. By 1927, Stalin had consolidated his rule. But during that period of the new economic policy, we came to the conclusion that the Soviet Union had given up forever the unbalanced, demented principles of communism and was now slowly somewhat inevitably, certainly irrevocably on the path toward capitalism and adopting our way of life, and we rushed into the Soviet Union and other Western countries did too and provided credits, convinced that the Bolsheviks had given up this crazy scheme.

By 1927, the collectivization and the purges began and a series of waves of terror were visited upon the Soviet people. The class of the rich peasants that had been created from 1921–27 was systematically eliminated by all methods, including shooting and starvation. Still, some people continued to do business during the 1930's. Anthony Sutton, in a brilliant three-volume study on the infusion of Western technology into the Soviet Union, published by the Hoover Institution at Stanford University, proved the case.

SPIRIT OF COOPERATION DURING WORLD WAR II

In the 1940's, during World War II, we were temporarily allied with the Soviet Union. We emerged in a spirit of good feeling, cooperation. But again, the Iron Curtain descended upon Europe and, of course, shut off the Soviet Union and it was a long while until we got started again.

In fact, it was in the 1960's that we first began these steps under the rubric of détente to try to engage the Soviet Union, to get it committed to it, and the rest of the cycles are very clear.

As I say, we're in another cycle and you have agreed. I believe that we need extra care and caution as we enter this cycle, Mr. Chairman, and I am absolutely convinced that holding this hearing and shedding light and publicity on the actions of people who claim to be pursuing peaceful activities—and I'm speaking now of Western and U.S. banks—ought to be highlighted.

I think their stockholders ought to know the risks and I think that the U.S. Congress has the right, indeed the duty, to decide issues like this and even issues that go beyond the authority being contemplated being given the President of the United States.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Mr. Allen, I appreciate very much your contribution to the committee with reference to this bill and I apologize for being a little late. I didn't hear all your remarks.

Has anyone yet discussed with you the letter from the Treasury Department concerning this legislation?

Mr. ALLEN. No, sir.

Senator DIXON. Have you looked at it?

Mr. ALLEN. Pardon me?

Senator DIXON. Have you seen that letter?

Mr. **Allen**. No, sir; I have not seen it. I gather that you're implying that the Treasury opposes the legislation.

Senator **Dixon**. Well, they've written a three-page letter here to the chairman. Copies have been given to members of the committee. And I just wanted to read you a couple of comments in the letter and I would appreciate your response.

On page 2, they say:

> Because money is fungible, particularly in a free market environment, it's very difficult unilaterally to impose effective international constraints on the aggregate flow of credit to a particular country.

At the bottom of the page they say:

> Unilateral United States controls would undoubtedly fail to achieve anything other than to deny United States lenders an opportunity to compete for Soviet and Eastern European business.

I would appreciate your comment about that.

Mr. **Allen**. Well, Senator, my first instinct, as soon as I leave this hearing, is to call Secretary Baker, my good friend, and reason with him a little bit on this issue.

This argument is absolutely identical to the argument we've heard for more than 20 years that if we don't do it someone else will get the business. If we don't sell, someone else will.

The point is, Senator, it is true that unilateral restraints don't achieve everything that one wants, but it's also preposterous to say that unilateral action cannot have its own results, that it cannot serve as an example to other countries, and that it is also true that if we argue that we should do nothing because we can do nothing unilaterally and it has no effect, that that is only going to give credence and, if you will, additional momentum to the decisions of other nations to proceed because, after all, they know the United States is a key factor in determining whether or not such loans should be made.

There exist mechanisms for multilateral controls. There is CoCom. It has been around a long time. There are other noninstitutional mechanisms. The North Atlantic Treaty Organization that can be utilized for this purpose.

Every time we come down to it again, it is a question of the businessmen and the bankers racing to Moscow and to Eastern Europe helter skelter, without any coordination, and before you know it, as the chairman has pointed out, the Soviets and Eastern Europeans have reaped another rich harvest.

Make no mistake about it, making a loan to Poland, Romania, Czechoslovakia—it is the same as assisting the Soviet Union. We insist on maintaining these fictions and those who want to trade and want to loan hide their arguments—I won't say maliciously—but perhaps naively behind the cloak of this broader argument.

Senator **Dixon**. Well, now, Mr. Allen, though, isn't it true—and I understand the position you take—isn't it true that in fact in the past when we've taken these actions in general they have turned out to be unilateral? The embargo is a good example of that, one that we've revisited many times. The end result of that embargo, incidentally inaugurated by a prior administration, has been devastating to our agricultural economy.

For instance, wouldn't it be a reasonable parallel to the suggestions of this legislation that we ought not to sell any grain to the Soviet Union?

Mr. ALLEN. No, sir.

Senator DIXON. You don't see that as any kind of comparative analysis?

Mr. ALLEN. No, sir. Not at all. I'm all for cash sales and I'm all for highlighting the fact that cash sales underscore the basic inefficiency and indeed the corruption within so-called scientific socialist economies of Eastern Europe.

Senator DIXON. But you see a distinction then between a cash sale of grain and a loan in which you make a full recovery of all interest and principal due you?

Mr. ALLEN. Yes, sir. Who says it's going to be recovered?

Senator DIXON. Well——

DEFAULT OF POLISH LOAN

Mr. ALLEN. Look at the Polish debt, for example. It's been rolled over. I have in my own mind made a classification of the Polish debt that equates it to Latin American debt. Then we have to ask the hard question: Is there really any prospect that these debts are going to be repaid? Do you really believe it? Then you might apply the same logic. If you say, no, I don't really believe that that Latin American debt will be redeemed, then you're going to have to apply the same principle to Eastern Europe debt, at least to Polish debt.

Part of the problem is that in the name of free enterprise our banking institutions proceed to Eastern Europe and to the Soviet Union to make these loans believing in many instances that they are supporting sound policy. That, in my judgment, is not sound policy. That's why in my statement, Senator Dixon, I more or less avoid focusing on the specifics of the pending bill, the bill before this committee, and argue that the broader context is more relevant before proceeding to such questions. I'm sure that you have all been through that many, many times, and Senators have a great and distinguished tradition of examining an issue from all sides.

I merely wish to point out that this strategic and historic context counts and while I would like to say to our bankers, "Go get the business, fellows," I can't say that because I feel that they're going to get the business, undercut our security and strategic interests, and I believe that it sets a bad example for other countries.

Senator DIXON. But, of course, when we didn't sell the Soviets the grain, Argentina and Brazil did. When we didn't sell the Soviets the Caterpillar tractors for the pipeline during the sanction period, our allies, the Japanese, sold them the Kumatzu tractors. I wonder if you're here to suggest that if we don't loan them the money, our friends and allies, the British, the French, the Japanese, the Italians and others won't loan them the money.

Mr. ALLEN. No, I can't suggest that. I think they will loan them the money.

Senator DIXON. Well, that's my question, Mr. Allen.

In this unilateral undertaking, I have no problem with your basic tenet. What bothers me is, in this unilateral undertaking, are we once again removing ourselves from the free market, currency being just like grain or any other product, an item that is readily available in other places? Aren't we just giving to those other markets in the world—I regret to say, many of them our closest allies—the opportunity to do business in our place?

Mr. ALLEN. In the broad sense, of course, we are. That also suggests that we need to redouble our efforts with our allies, Senator.

Senator DIXON. I agree with that. I'd like to sit there at the table with you and be your associate in this presentation if we were able to persuade our allies of that. I was one of those from the Agriculture Committee who voted to sell all the dairy products on the free market when we had caves full of cheese and milk. And the next day the Ambassador to New Zealand came to me and said, "What have you done to our country? The only thing we sell on the foreign market is our dairy products." I said, "Gee, Mr. Ambassador, I was just acting in the interest of the United States."

But we never sold our dairy products, and what great allies they are. They won't let our ships with nuclear weapons into their harbors. I join with you, Mr. Allen, but what bothers me, as a Senator that represents Illinois, which builds Caterpillar tractors and grows corn and beans, is that every time we do something like this, I shoot Caterpillar tractor and my farmers in the foot.

Mr. ALLEN. Senator, I understand your perspective and having been involved in the whole question of the pipeline, for example, I can only say that I'm sensitive, having discussed it with you at the time and also with the distinguished minority leader of the other House, Congressman Michel, who had a very difficult time with that problem.

The pipeline I consider to be something really entirely separate. I opposed the pipeline. I thought it was a mistake and at one point we could have killed the pipeline in Europe had we demonstrated leadership. It was actually possible. We were the new boys on the block and some were not prepared to go as far as I thought we could go and it would have only taken one single, simple utterance by the President-elect of the United States that he would not support the credits for the pipeline and the whole thing would have collapsed. I can guarantee you that's an accurate assessment. I won't occupy your time with that this morning.

I would like to respectfully point out, however, Senator Dixon, that the bill before this committee being considered today does not cut off East-West trade. It merely gives the President the authority to regulate loans to Eastern European and other adversary countries. That is all it does.

PRESIDENT HAS BEST PERSPECTIVE OF OUR NATIONAL INTERESTS

So we have to assume that the President, who has a much better perspective than anyone else in this country, sitting as he does at 1600 Pennsylvania Avenue, of the long-term national interests and knows how to, as it were, to play the various elements or which arrows to put in his quiver at which time, certainly far better than we do, ought to be given that opportunity to make judgments in the national interest. No one is saying that loans will not be made. One is only saying that the President will now have that authority and it won't be a scattered authority and located in many different places.

We are beginning to pull together now with this legislation and hopefully with legislation that will follow the disparate elements of a comprehensive trade strategy. After all, the Senate and the House complain that the administration doesn't have a trade strategy. Here you are about to give the President a tool that would allow him to fashion and craft a trade strategy that makes sense. So while enormously sympathetic and understanding of the dilemma in which you find yourself with respect to unilateral versus our failure to do something multilaterally, I respectfully argue that this bill deserves the support of every Senator and, not only that, the administration ought to be, shall I say, pressured, persuaded, cajoled into making yet another effort to pull together with our allies at a time of enormous importance for the world in terms of technology and the need to guard that technology, providing the ability to buy technology whether directly through Eastern European countries or cutouts in Los Angeles in California or wherever they may be, the time is now to take these steps in my view, sir.

Senator **Dixon**. Well, my time is up, Mr. Allen. I might only say I think you're extremely persuasive. I'm supportive of everything you say on a multilateral basis. I am bothered about it from the standpoint of a unilateral concept.

The **Chairman**. I would just say that to carry these arguments just a little bit further, it is correct that the unilateral enforcement has not worked too well and we have always heard that. We heard that in the Export Administration Act—"We can't do this because somebody else will fill in the gap." But we make virtually no efforts to encourage our allies to be supportive.

I gave up on the Carter administration with this argument on the Yamal pipeline. I and some others on this committee, were trying to kill that turkey way back in the Carter administration. We are disappointed that we had no impact on the Reagan administration. By the time the administration was in power and we finally convinced people down there to be against it, it was too late.

Mr. **Allen**. With certain notable exceptions, might I point out?

The **Chairman**. That's correct. But I had hoped that when President Reagan came in we could kill it, but by the time they did decide to oppose it the train was long out of the station.

But the point that I wanted to make about credits and loans, even if we assume that we should go ahead and make them, Senator Dixon, the thing that has always bothered me is why we treat the Soviets and the Eastern bloc nations on better terms than we treat your farmers in Illinois. In the Yamal pipeline, far apart from the issue of whether the pipeline should have been built and Western European countries should be dependent upon that Soviet natural gas is another issue. I couldn't explain to the people of Utah when there was a 21.5-percent prime interest rate while the banks of the Western countries were making loans at 7 or 9 percent to the Soviet Union and that it was not economically feasible to build a United States pipeline for natural gas across Canada to the United States because the interest rates were too high. So commercially you could not justify it, but we made loans to them at 7 and 9 percent. Now if we're going to make loans to them, at least treat them at the market rates. At least treat them the same as our farmers, our mortgage borrowers, and so on. That is one that I defy anybody in the banking community to defend to me, why better terms to the Soviet Union than to people in our own country and that we can't build a pipeline but they can.

Now I don't think anybody can sit here with a straight face and tell me why we do that. So unilaterally or otherwise, why do we make better terms to them? Why do our allies continue to snub their nose at us? Why do we keep 250,000 troops in Europe defending them when they won't pay their fair share for the defense of their own country? And then want to play these games.

UNITED STATES IS INCREDIBLY NAIVE

If Japan wants to sell Komatsu tractors and kill our chances of selling Caterpillar tractors over there if the deal is done, then why don't they try and sell Toyotas in Moscow? See how good the market is in Russia for Toyotas, Nissans, and all the others. We're damned fools. We are so incredibly naive. These cycles you talk about. You don't have to have an education. Somebody out there with a grade school education in Illinois can understand what I'm talking about. Why can't all the economists? Why can't the politicians? Why can't our Government leaders understand what we're doing? You don't have to have 30 years of foreign policy experience like you've got to understand these cycles. And the stupidity—naiveness is too nice—it's stupidity that we continue to engage in these types of activity at the expense of our own people. Interest rates are higher in the United States today for our consumers because of the loans to Central and South America and Third World countries, but the naiveness continues. I wish I understood. It's time I think we ought to start telling—here's Mr. Superheart, strong on defense, supporting our allies, but I think it's time we started telling them, "Look, if you want 250,000 troops to defend you against the Soviet Union, then you start being a little cooperative on these other issues." We provide a total defense umbrella for Japan. I lived in Japan. I served in Japan. I have great respect for the Japanese. But why should we provide the total defense umbrella for their country and all of Southeast Asia and the Far East while they do what they're doing to us tradewise?

And I'm not a protectionist. I'm not saying to them, "Don't sell your products here." But maybe if they put 1.5 percent into the defense of their country maybe they wouldn't have so much money to compete with us in domestic goods. It's beyond my comprehension, Mr. Allen, to understand our foreign policy in this area.

Mr. Allen. Just a very brief remark, if I may, Senator, with respect to your remarks about Japan. It is indeed true that we provide that umbrella and it's also indeed true that we created the system by which only we would provide that umbrella. With some credit to Japan, it appears now that Japan will move through a series of consensus-building procedures that will allow them to spend slightly more than 1 percent for its own defense.

But I would like to point out at the same time that we should never lump all the Asian countries together. Our friends and allies in Korea are spending 6 percent of GNP and their trade surplus with the United States is not nearly as offensive, for example, as is Japan's.

So you're absolutely right. There are ways and means if the President determines that it shall be to get our allies onboard in joint enterprises. We are about to apparently go into some rather heady intervention in the exchange markets. We had a major meeting that appeared to be successful at least from some people's point of view over the weekend of Finance Ministers of five major industrialized nations. If we can do that, why can't we also pull together on the same oar of posing a united front to our common enemy, which is basically the Warsaw Pact and all its associated members?

The CHAIRMAN. Probably because the European countries will never learn their lesson. That's why they have been involved in so many wars in their history because they never learn from the previous one.

Senator DIXON. Mr. Chairman, may I interrupt for just a moment? I have to go back to the Armed Services Committee. But may I have leave to submit some written questions to First Chicago and Citibank?

The CHAIRMAN. Certainly.

Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. I have a time problem too on Energy, so I would like to forego my questions and hear the next panel.

The CHAIRMAN. Thank you, Mr. Allen. We appreciate your willingness to be here.

Mr. ALLEN. It's a pleasure, Senator. Thank you very much. Senator Hecht, it's nice to see you.

The CHAIRMAN. Could we have the next panel come up, the Honorable Rurarz, former Polish Ambassador to Japan; and Mr. Howard Ruff, chairman, Free the Eagle Citizen's Lobby.

Mr. Rurarz, would you like to begin, please.

STATEMENT OF ZDZISLAW M. RURARZ, FORMER POLISH AMBASSADOR TO JAPAN

Mr. RURARZ. Thank you, Mr. Chairman, for inviting me to testify before your committee and apart from the comments which I have provided to you a couple days ago, I should like to make a brief oral statement.

In my written comments, I was trying to prove that the Soviet bloc countries are quite simply overstating the figures concerning their economic situation to make them attractive for Western banks and companies to invest in them. And this is particularly true of East Germany. Such countries, like for instance Hungary or even Poland, are not that much falsifying the statistical figures, although they also do and, therefore, their economic performance looks much worse than, for instance, that one for East Germany.

When it comes to East Germany, which is not a member of the General Agreement on Tariffs and Trade and, of course, not of the

International Monetary Fund, when it comes to their statistics they almost may report anything and, unfortunately, this anything is believed.

EAST GERMAN ECONOMY IS EXTREMELY INEFFICIENT

Being more specific—by the way, I know East Germany. I was several times in that country, as well as in West Germany. I speak German so it was quite easy for me to know many things. But when it comes to East Germany, their economy is extremely inefficient. It's organized in the so-called combines. There are 126 combines in all, which are very centralistically oriented and as such inefficient economically.

Why recently East Germany is reporting to be that much successful when it comes to economic growth, I cannot quite simply understand. I don't know what really has happened that there is such a dramatic improvement in the performance of their economy.

May I add that the Soviets cut the supplies of oil to East Germany by more than 5 million tons and East Germany was importing 22.7 million tons in 1982. The prices of Soviet oil have gone up on the meantime. And why East Germany succeeded in amassing more than $5 billion in reserves which makes them that much more attractive now to many banks, I must say I don't understand this. There must be a very clever disinformation operation, economic disinformation, of course, which makes the economic figures of East Germany look that good and, for that reason, some of the banks, including unfortunately American, are quite simply falling into their trap.

This is even more mysterious to me that West Germany, who knows of course much better what is going on in East Germany, is not that generous with credits, especially with the terms of credits, as unfortunately some of the American and Japanese banks seem to be. This I quite simply cannot understand and I believe it is a very clever economic disinformation operation which is very much successful, at least for the time being, and if it continues like that and there is no control by the governments of the Western countries, there can be another credit disaster as the case was in the 1970's where many of the banks were overextended with their credits to Eastern Europe and where now they are facing the trouble of being repaid.

So after this brief oral statement, I am ready to answer any questions on this subject. Thank you.

[The prepared statement of Mr. Rurarz follows:]

STATEMENT BY DR. ZDZISLAW M. RURARZ, FORMER AMBASSADOR OF POLAND TO JAPAN, BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS OF THE UNITED STATES SENATE AT ITS LEGISLATIVE HEARING ON S.812 HELD ON THURSDAY, SEPTEMBER 26, 1985, AT 9:30 a.m., DIRKSEN SENATE OFFICE BUILDING, WASHINGTON, D.C.

Mr. President,

I am greatly honored for being invited to testify before your Committee in relation with hearings on S. 812.

For obvious reasons, I cannot recommend anything concerning the draft piece of the legislation, but I will avail myself to answer briefly the questions posed to me by Senator Jake Garn, Chairman of the Committee, which he addressed to me on August 15, 1985.

But before I answer those questions, I should like to make a few introductory comments. Specifically, on issues raised in the Frederick Kempe´s article "East Germans Benefit From U. S. Bank Credits that Don´t Call For Human Rights Concessions", as published by The Wall Street Journal on March 19, 1985.

Referring to its purely economic side only, I can wholly confirm all the author´s observations and conclusions and add another observation on my own.

Namely, F. Kempe in one place says that: "...East German economic reporting remains imprecise".

That is absolutely true, except that this is true of all the Soviet Bloc countries.

May I state in this place, that all the statistical data officially published, with many not published at all, are more or less "doctored". This is being done not only by respective professionals from various civilian bodies dealing with such publications, but by specialists from intelligence and counter-intelligence services as well. The statistical data are arranged in such a way that they are as far from the truth as possible and in general are a deliberate disinformation ploy, targeted mostly at the West.

Moreover, even those responsible for the mentioned "doctoring" of statistics, do not know the truth either. This is because the lower echelons, that is factories and other reporting units, perennially lie before upper echelons.

Let me give the example to this end from the USSR itself.

Thus the daily organ of the Soviet Government Izvestia writes on July 12, 1985 the following:

" ...Annual plan/in the Frunze wood plant of the Kirghiz Republic/ was reported as fulfilled in 103.6 per cent, while in fact was fulfilled in 93.9 per cent only...In 1983 statistical reports on cargo shipments in 925 truck enterprises belonging to 34 ministries were controlled and in 560 of them, that is in 60 per cent of the total, the "pripiski", or upwardly falsified data, were established".

Most naturally, the overall falsification of statistical data cannot be revealed by anything like Izvestia and not only for political reasons, but because there is really nobody in the USSR, or elsewhere in the Soviet Bloc, who truly knows the truth to this end.

The above quoted example is only the tip of the iceberg.

For example, I was told by some very well-informed Bulgarians in 1981 that in 1980 the Bulgarian economy registered no growth whatsoever. Nevertheless, the political decision was to publish the GNP's growth at 5.7 per cent.

Hence I doubt strongly that the performance of East Germany's economy is as much vigorous as reported, especially in the domain of the productivity of labor which looks to me suspiciously high.

I am rather inclined to believe that East Germany deliberately disseminates this kind of disinformation in order to attract fresh credits to its would-be robust economy, which in fact is a very ailing one.

By the way, it is not for the first time that the Communist countries play the same trick. It is only to be wondered why so many in the West cannot detect this and despite of some seven decades of experience.

Why certain US banks may know East Germany better than its brethren in West Germany, remains a mystery to me.

Another comment I should like to make it is that the Soviet Bloc economies are in such a poor shape, and more is to come, that they simply are a great commercial risk to any creditors. Careful readings of Bloc's own statements, like those delivered at the 40th Comecon session in Warsaw last May, or those delivered by Gorbachev himself, especially the one on June 11, confirm that. Even "doctored" statistics must admit partly the truth to this end.

Mr. President,

Having first-hand experience with the so-called socialist economy I can assure you that unless central-planning is not abandoned and the economy not reprivatized, such an economy has no future before it.

Moreover, with dwindling supplies of fuels, raw materials and labor, the Soviet Bloc economies, some of them also burdened with external debts, are going to perform even still more poorly. Very soon some other factors may be at work as well. Namely, the adverse effects of stagnation and even fall in real wages, inadequate level of investments and continuing increase in defense spendings. In sum, all the above may bring about the so-called negative growth of the Soviet Bloc economies, if this is not the case already now, although deceitfully concealed by "doctored" statistics.

As to other aspects of the issue under consideration, may I merely say that in the seventies the West extended loans to the Soviet Bloc somewhere in the range of 80 billion dollars, what is an equivalent of some 50 thou. tanks.

I do not think any comment is necessary here.

Mr. President,

Let me now pass to the questions posed in the said letter to me.

Question No. 1: To what extent do loans contribute to the military strength of the Soviet Bloc countries?

Answer: It is already well-known that Soviet Bloc countries, the USSR especially, have very much war-oriented economies. On the average, those economies are at least twice as much burdened with war spendings than is the case in the West. Adding to this all other spendings, like for security police and the like, the burden is even still higher.

Therefore, any loans to such economies mean relief to them. Moreover, on many occasions they can be the only way those economies may acquire necessary capital and know-how to start certain productions of arms and munitions. Centrally-planned and managed economies can easily shift resources from one domain into another one and hence any opportunity to receive external financing of any sort is a boost to them, in many instances primarily in defense sector.

These are the truisms but they should be repeated all the time.

Question No. 2: In what other ways might such loans be harmful to the interests of the United States and her allies?

Answer: The Soviet Bloc, especially its center the USSR, is hostile toward the United States and the West in general and to the point threatening their very existence.

In such a situation, anything helping the Bloc's military might, whether directly or indirectly, should be viewed accordingly.

Should the Bloc be willing to abandon its politico-strategic goals and its nonsensical socio-economic system, then one might ponder helping it with loans, even on concessionary terms.

But nothing like that is the case and it is hard to see any encouraging signs to this end. On the contrary, all the official pronouncements, Soviet in particular, do not promise any change in the past and present attitudes. On the contrary, it looks, at least I am convinced of that, as the Soviet economy move to something like a war footing. Even Poland's battered economy makes the same impression.

For this simple reason, anything like fresh Western loans, US first of all as some unfortunate examples of recent times suggest, would boost the Bloc's war effort. Especially, that the Bloc acts on a highly selective basis and knows perfectly well what it wants. Western businesses and banks may think the Bloc dances as they play. I am pretty sure it is the other way round.

May I also add that the Bloc's ability for selective approaches have also the other side of the coin. Namely, the Bloc deliberately creates various lobbies and pressure groups by concentrating certain of its imports and exports in certain countries or even certain companies and banks only.

That such selective approaches can be detrimental to the United States and her allies, goes without saying.

Question No. 3: Should the President be given authority to control capital transfers to the Soviet Bloc?

Answer: Having had a long experience in foreign economics and politics, I cannot believe that in the contemporary world anything like "pure" trade and finance flows exist. They surely do not exist in the Soviet Bloc. Politics has even the precedence over economics in this case.

With all the respect for the smartness of private businesses of all kinds, I am absolutely sure that in the end they are not an equal partner to State-trading organizations behind which all the State power is hiding.

By saying this, I am of course aware of the fact that particular companies, or even particular businessmen, may truly benefit from economic relations with the Soviet Bloc. But any expanded relations of this sort, with loans being indispensable prerequisite to them, as the Bloc's import ability could be otherwise very meagre, cannot be really left at the mercy of fate only. Should this be the case, the fateful consequences of that can be easily anticipated.

Mr. President,

When reading your question I was somehow taken aback, because I simply cannot imagine that the President of a global power could have no authority to control loans extended to another global power whose hostile intentions toward this country are not a secret to anybody with minimum dose of a common sense.

Well, such an authority, in my view, is already long overdue.

Question No. 4: To what extent do loans to Eastern European countries benefit the Soviet Union?

Answer: In the light of all the above my answer cannot surprise anybody. Eastern Europe is Soviet-dominated. Thus anything helping it may help ultimately the USSR. The only exception can be humanitarian aid and independently distributed, like for example by the Catholic Church in Poland. But such a humanitarian aid is not to the liking of the Bloc, or more specifically the Soviets.

Apart from such times and countries where US loans could help Eastern Europe become freer, something rather only faintly possible, one must be prepared otherwise for the situation where any loans and transfers of know-how, frequently financed by them, finally benefit the USSR.

One must remember that almost half of the capital goods and know-how imported by the USSR originates in Eastern Europe. In chemical products the proportion is even higher and in all other industrial products the situation is fairly similar to that one in capital goods.

It is then quite normal that anything boosting Eastern Europe´s production, agricultural including, as the USSR shows ever greater interest in imports of food from Eastern Europe, must benefit the USSR. Especially, that Eastern Europe´s economies are so much dependent on the Soviet economy that they have hardly any other alternative than to comply with Soviet demands. And the Soviets demand ever more products and ever better ones. Moreover, they also demand from Eastern Europe to participate in the so-called joint investments in the USSR in various projects. It may thus happen that loans to Eastern Europe enable it to credit the USSR in turn.

At the same time I would strongly advocate, and precisely for the reasons mentioned above, that the President could have discretionary powers concerning loans to Eastern Europe and could maneuver with them as his policy options might be opportune.

Mr. President,

This is a very delicate problem. Although I have clearly said that anything Eastern Europe gets may ultimately land in the USSR, one should at the same time have the eyes and ears widely open and seize any opportunities as they might surface.

There are always the exceptions from the rules and particularly this country cannot afford for the luxury of not making use of this proverbial wisdom.

I would be only glad to elaborate more on that orally, should such a need arise.

Mr. President,

In conclusion, I should like to repeat once more that the Soviet Bloc economies are in a very poor shape and everything suggests that their shape will be even still poorer.

At the same time, nothing suggests that they have come to reasons and embarked on the path of genuine change.

For these simple reasons bailing them out of trouble by fresh loans, as I can figure out rather not too well-thought, would be even more reckless than the case was in the past where some still believed that not enough experience existed.

It is unimaginable for me that the President of the United States could be deprived of the control over the resources of his country transfered to the hostile Bloc. National security, I understand, is indivisible.

It is not in the best interest of this national security to transfer the resources from this country to the Bloc in question where not only its combativeness cannot be reduced because of that, but actually can be only increased and even the loans themselves never repaid.

Yet, I do not exclude a possibility that in certain times and under certain circumstances such transfers may be the case. But the decision to this end cannot be left to the judgement of the people whose perceptions of various issues are understandably limited and whose even sound purely commercial judgement can be impaired as well because of the lack of proper information and abundance of disinformation.

I thank you, Mr. President.

The **Chairman**. Thank you.
Mr. Ruff.

STATEMENT OF HOWARD J. RUFF, CHAIRMAN, FREE THE EAGLE CITIZEN'S LOBBY

Mr. **Ruff**. Mr. Chairman, my name is Howard J. Ruff. I am the chairman of Free the Eagle, a grassroots citizens lobby supported by 265,000 contributors across the United States.

CONCERNED FOR IRRESPONSIBLE LOAN PRACTICES OF U.S. BANKS

Free the Eagle is concerned with the devastating present and future impact on our economy of the irresponsible loan practices of U.S. banks, the International Monetary Fund, the World Bank, and the regional development banks.

Free the Eagle led the fight in 1983 against increased funding of the IMF. We were and still are of the opinion that the special subsidies to big banks runs contrary to the values of the vast majority of Americans, is bad for America and is harmful to the citizens of debt-burdened Third World countries.

We wish to offer our support and urge all Members of the Senate to cosponsor the bill that is currently before this committee, S. 812, and then vote for this legislation when it comes to the floor. I want to offer our reasons for supporting this bill and also suggest some ways it can be strengthened.

S. 812 addresses the problems created by the unregulated placement of international loans by private U.S. banks. The simple truth is that private banks who loan their depositors' money to sovereign governments are making and changing U.S. foreign policy.

These banks are motivated almost solely by profit, and are unwilling to weigh the broader considerations of national security. It is appropriate for Congress to consider legislation to curb such loans.

Taking this stand on this issue presents a serious philosophical problem for me, as I have been a long advocate of a free market and have been generally opposed to Government interfering in these policies in private transactions, but when national security is at stake, I have to reverse my position.

Most of the so-called money center banks have long since compromised their net worth by loaning to insolvent governments who may have no intention or ability to repay. The chart which we submitted along with my written testimony indicates the percent of these excess problem loans to the total equity of these banks. For example 67 percent of the equity of Bank of America is in endangered from its foreign problem loans. They have shown little regard for risk, even as these debtors have flirted with defaults.

While European, Japanese, and smaller U.S. banks have shied away from such exposure, the larger banks have failed to do so. The money center banks fail to see the writing on the wall, apparently because they have counted on the American taxpayer to fund international bailout institutions, such as the IMF, the World Bank, and even the Federal Reserve, which loan money to the debtors, so they can service their debts. Given this confidence, no risk has been too great to assume.

Morever, these money center banks make little or no distinction between loans to Communist governments and non-Communist ones. Money center banks rely heavily on the happy talk of Communist countries being good credit risks, because the Soviet Union won't allow them to go bankrupt.

This simply does not reflect reality. Several of these countries have already defaulted and others operate under the euphemistic phrase for default, grace period.

Such loans violate three basic principles for sound financial and foreign policy.

Control over capital is a significant strategic weapon.

There is presently a lack of control over any bank that wants to lend money to a sworn enemy of the United States. Present law ignores the wide-scale marketing of loans to Communist countries until an emergency is declared. While S. 812 makes it easier for the President to prohibit these loans, we must also create standards by which to judge such loans.

Surely loans for military or high technology, such as computers, police surveillance equipment, et cetera, ought to be prohibited now. Moreover, any such loans should never be guaranteed by U.S. taxpayers. As you may know, 17 billion dollars' worth of loans to the Soviet Union are guaranteed by Western governments.

THREE SOVIET SATELLITES HAVE DEFAULTED

At least three Soviet client states, including Poland, Cuba, and Nicaragua, have defaulted on loans to private banks. The Soviet Union shows no fear in letting them default. These puppet governments pose some of the gravest risks to the United States and its allies by serving as bases for espionage and aggression against their neighbors, while crushing the human rights of their people.

Second, loans to Communist governments are used to assist other Communist countries in global political actions.

The recent loans to East Germany of first $500 million and then $600 million are a classic example of how the money spills over to other Communist dictators. Subsequently, East Germany extended $84 million in cash and credits for the Communist government of Nicaragua. Nicaragua received cash, trade, and training from East Germany for their Marxist regime. Meanwhile East Germany had $5 billion in cash reserves in the bank.

We invite you to draw your own conclusions. What makes this episode even more troubling was the U.S. Ambassador, Rozanne Ridgeway, sent two East German defectors, Dr. and Mrs. Bernard Schnappauf back into East Germany's hands. Apparently Ambassador Ridgeway threw them out of the Embassy so that the East Germans would not have any conflict that could interfere with the pending discussions over their loan from Western banks. Just imagine, if we hadn't given East Germany their freedom-seeking defectors, they might have gotten mad and refused the loan.

The damaging impact of our banks on our principles is troubling. For example, the West German banks have usually received human rights concessions from East Germany. In this case, our officials are making concessions to human rights violations, when U.S. banks loan money with no strings attached. The time for regulatory review has come.

Third, Communist regimes have a record of manipulating their balance sheets, as the gentleman on my right has indicated, to create the false impression that they are creditworthy.

Take the case of the top secret documents confiscated in the Grenada liberation. The documents show that Grenada's economic situation was desperate. Money was urgently needed. Grenada sought IMF loans for socioeconomic assistance while it constructed a military airport with part of the money. Grenada did not intend to spend IMF loans to improve its economic status. The international airport was a commercial front for what was, in fact, a military airfield. The IMF may have helped to prevent such misdeeds by imposing restrictions on Grenada's loans. Grenada, however, did not intend to abide by such restrictions. They did not intend to pay back their loans nor use them to upgrade Grenada's sinking economy.

It is evident from the captured Grenada documents that Maurice Bishop understood the setback an IMF evaluation would impose on their revolution and the need to obscure these facts from the IMF to prevent such an evaluation.

Grenada decided to fraudulently adjust their figures to confuse the IMF. For example, and I quote,

> Maurice Bishop suggested that we use the Suriname and Cuban experience in keeping two sets of records in the banks for this purpose.

Based on Grenada's phony set of books, the International Monetary Fund approved $14.1 million in loans to the Communist Government of Grenada. This loan was rescinded after the U.S. liberation, but the incident shows how dangerously easy it is for Communist countries to receive unregulated loans which they use to perpetrate oppression.

Robert Heinlein, one of my favorite authors, once said, "He who refused to read history has no past and no future."

The same document shows that the Soviets were pulling the strings in Grenada. Thus, it should surprise no one if the puppet master acts in the same way as his puppets.

Recently, the Soviet Union borrowed $200 million from First Chicago. In 1984, a consortium of 31 Western banks announced a loan of $250 million. The Soviet Union is presently carrying on a brutal war on a civilian population and have committed heinous mass murders reminiscent of Adolph Hitler. They've killed approximately 1 million Afghan men, women, and children and are prepared to kill more. The Soviets are also funding terrorists in many parts of the world which attack this country's military bases, allies, and the free people of other countries.

They maintain a huge force of internal spies to terrorize their own people, and its present dictator, Gorbachev, rose to power with the help of the KGB, which has become the greatest political force in the Soviet Union today, and is in clear command of its Government. So when you see a United States bank loaning the Soviets $200 million, you'll understand our alarm.

SOVIET UNION'S ECONOMY IS CHRONICALLY ILL

At the same time these atrocities are taking place, the Soviet Union's own economy is chronically ill because of inefficient Communist Party planning and reliance on slave labor, while it pours twice as large a percentage of its budget as we do into military arsenals.

Clearly such loans impinge on the foreign policy powers of the President and the Congress. To take federally insured deposits and loan them to the Soviets without making them accountable for the use of these loans nor imposing limitations strikes the Free the Eagle members as highly questionable.

It seems to us to be sheer insanity for the United States to permit loans to the Soviet Union which allows them to direct other resources into nuclear missiles aimed at cities like this one. This then requires us to play catchup by increasing our military budgets, which contributes to the huge deficits which threaten the very foundations of our economy.

I am the father of 12 children. I have nine grandchildren, and how do I explain to them that part of the debt burden that we are going to dump onto them was caused by our buildup of our enemies. When my little girl who is 2½ years old was born, her share of the national debt was $4,300. Now it's almost $8,000. By the time she's 21, it will be close to $500,000. And in my opinion, much of this is caused by our need to play catchup ball with our adversaries, whom we have financed.

Neither the Export Administration Act nor any other law contains sufficient directives preventing questionable international loans from endangering our national security and our economy. The present International Emergency Economic Powers Act does offer some economic protection, but it can only be exercised by the

President in an emergency. It is better to prevent an international emergency than to have to later cope with the results of one. S. 812 gives authority to the President to help prevent loans of this kind from reaching crisis levels. Therefore, I would urge you to strengthen this bill by requiring the President to eliminate all loans to Communist countries for technical, high tech, and military purposes.

The flow of investment and capital across national borders should, in principle, be free and unrestricted, but such a policy should not include the Soviet Union, because of the resulting hardships suffered by the United States, in terms of deficits and the competition for capital elsewhere in our economy.

I would urge you to focus your attention on the folly of such lending to the U.S.S.R. Currently, the total debt owed to the West by the Soviets is $28.8 billion. In fact, 61 percent of the total outstanding loans to the U.S.S.R, or $17.67 billion, are guaranteed by Western governments. This means that the risks of Western banks and businesses doing business with the Soviet Union are reduced significantly by the Government loan guarantees, with the risks having been transferred to the American taxpayer.

We and our allies are indirectly subsidizing their subversion, terrorism, and military buildup. A visitor from another planet would pronounce us crazy.

This 61 percent represents a much higher percentage of loan guarantees than Brazil, Mexico, or Argentina have. Their respective percentages of guaranteed loans is 19, 10, and 15 percent. Poland, in keeping with the Soviet pattern, has the second highest percentage of Government guaranteed loans at 38 percent.

Presently, several Communist borrowers are in default, as indicated in appendix G, submitted with this testimony, but they're being given grace period after grace period without any repayment penalties.

The accompanying chart, also submitted, shows how much these countries owe private lenders and how many years grace the banks have given these borrowers.

Don't our farmers deserve at least as long a grace period on their loans as Communist Cuba, which has a 2-to-5-year grace period?

While Communist governments receive billions of American dollars and demand extraordinarily long grace periods for repayment by threatening to revoke the promise to repay altogether, Americans are paying historically high rates, farms are being repossessed, and banks are failing. America has reached a critical juncture, where she cannot afford such abuses. These loans undermine our national security, destroy the authority of the President to conduct foreign policy, and finance outlaw dictators.

I find it ironic and hypocritical to press for sanctions against South Africa while permitting loans to the second largest gold producer, the Soviet Union. At least in South Africa, miners come and work voluntarily while mines in the Soviet Union are mined by slave laborers.

Mr. Chairman, if we continue to make large loans to the Soviet Union, it is conceivable that with all of the loan problems that are faced by our financial institutions in the real estate, farm, and Third World country areas, that our banks could be very delicately balanced on the brink of a collapse at some future time, and I find it inconceivable that we do not at least admit the possibility that the Soviet Union might be tempted to give us a push at such a time, and, in fact, we are reaching the point now where our loan exposure to the Soviet Union is such that we now, and the system, and certainly the American banking system, has a vested interest in preventing the collapse of international communism, in order to avoid financial defaults.

I urge you to increase the power of the President to exercise his control under the Export Administration Act, to prevent Communist countries from receiving any more unregulated loans. The foreign policy of this country ought not be undermined by such greed. The national interest demands greater control, greater accountability, and higher standards of conduct.

Thank you, Mr. Chairman.

[Complete prepared statement follows:]

TESTIMONY OF HOWARD J. RUFF, CHAIRMAN OF THE BOARD OF FREE THE EAGLE, BEFORE THE SENATE BANKING COMMITTEE, SEPT. 26, 1985 IN SUPPORT OF S. 812.

MR. CHAIRMAN, MY NAME IS HOWARD J. RUFF. I AM THE CHAIRMAN OF FREE THE EAGLE, A GRASS ROOTS CITIZENS LOBBY SUPPORTED BY 265,000 CONTRIBUTORS ACROSS THE UNITED STATES.

FREE THE EAGLE IS CONCERNED WITH THE DEVASTATING PRESENT AND FUTURE IMPACT ON OUR ECONOMY OF THE IRRESPONSIBLE LOAN PRACTICES OF U.S. BANKS, THE INTERNATIONAL MONETARY FUND, THE WORLD BANK, AND THE REGIONAL DEVELOPMENT BANKS.

FREE THE EAGLE LED THE FIGHT IN 1983 AGAINST INCREASED FUNDING OF THE IMF. WE WERE AND STILL ARE OF THE OPINION THAT THE SPECIAL SUBSIDIES TO BIG BANKS RUNS CONTRARY TO THE VALUES OF THE VAST MAJORITY OF AMERICANS, IS BAD FOR AMERICA AND IS HARMFUL TO THE CITIZENS OF DEBT-BURDENED THIRD WORLD COUNTRIES.

WE WISH TO OFFER OUR SUPPORT AND URGE ALL MEMBERS OF THE SENATE TO CO-SPONSOR, THE BILL THAT IS CURRENTLY BEFORE THIS COMMITTEE, S. 812, AND THEN VOTE FOR THIS LEGISLATION WHEN IT COMES TO THE FLOOR. I WANT TO OFFER OUR REASONS FOR SUPPORTING THIS BILL, AND ALSO SUGGEST SOME WAYS IT CAN BE STRENGTHENED.

S. 812 ADDRESSES THE PROBLEMS CREATED BY THE UNREGULATED PLACEMENT OF INTERNATIONAL LOANS BY PRIVATE U.S. BANKS. THE SIMPLE TRUTH IS THAT PRIVATE BANKS WHO LOAN THEIR DEPOSITORS' MONEY TO SOVEREIGN GOVERNMENTS ARE MAKING AND CHANGING U.S. FOREIGN POLICY. THESE BANKS ARE MOTIVATED ALMOST SOLELY BY PROFIT, AND ARE UNWILLING TO WEIGH THE BROADER CONSIDERATIONS OF NATIONAL SECURITY. IT IS APPROPRIATE FOR CONGRESS TO CONSIDER LEGISLATION TO CURB SUCH LOANS.

MOST OF THE SO-CALLED "MONEY CENTER" BANKS HAVE LONG SINCE COMPROMISED THEIR NET WORTH BY LOANING TO INSOLVENT GOVERNMENTS WHO MAY HAVE NO INTENTION OR ABILITY TO REPAY. THE CHART IN APPENDIX A INDICATES THE PERCENT OF THESE EXCESS PROBLEM LOANS TO THE TOTAL EQUITY OF THESE BANKS. FOR EXAMPLE, 67% OF THE EQUITY OF BANK OF AMERICA IS IN ENDANGER FROM ITS FOREIGN PROBLEM LOANS. THEY HAVE SHOWN LITTLE REGARD FOR RISK EVEN AS THESE DEBTORS HAVE FLIRTED WITH DEFAULTS. WHILE EUROPEAN, JAPANESE AND SMALLER U.S. BANKS HAVE SHIED AWAY FROM SUCH EXPOSURE, THE LARGER BANKS HAVE FAILED TO DO SO. THE "MONEY CENTER" BANKS FAIL TO SEE THE WRITING ON THE WALL, APPARENTLY BECAUSE THEY HAVE COUNTED ON THE AMERICAN TAXPAYER TO FUND INTERNATIONAL BAILOUT INSTITUTIONS, SUCH AS THE IMF, THE WORLD BANK, AND EVEN THE FEDERAL RESERVE WHICH LOAN MONEY TO THE DEBTORS, SO THEY CAN SERVICE THEIR DEBTS. GIVEN THIS CONFIDENCE, NO RISK HAS BEEN TOO GREAT TO ASSUME.

MOREOVER, THESE "MONEY CENTER" BANKS MAKE LITTLE OR NO DISTINCTION BETWEEN LOANS TO COMMUNIST GOVERNMENTS AND NON-COMMUNIST ONES. "MONEY CENTER" BANKS RELY HEAVILY ON THE HAPPY TALK OF COMMUNIST COUNTRIES BEING GOOD CREDIT RISKS BECAUSE THE SOVIET UNION WON'T ALLOW THEM TO GO BANKRUPT. THIS SIMPLY DOES NOT REFLECT REALITY. SEVERAL OF THESE COUNTRIES HAVE ALREADY DEFAULTED. OTHERS OPERATE UNDER THE EUPHEMISTIC WORD FOR DEFAULT, GRACE PERIOD.

SUCH LOANS VIOLATE THREE BASIC PRINCIPLES FOR SOUND FINANCIAL AND FOREIGN POLICY.

1) CONTROL OVER CAPITAL IS A SIGNIFICANT STRATEGIC WEAPON.

THERE IS PRESENTLY A LACK OF CONTROL OVER ANY BANK THAT WANTS TO LEND MONEY TO A SWORN ENEMY OF THE UNITED STATES. PRESENT LAW IGNORES THE WIDE-SCALE MARKETING OF LOANS TO COMMUNIST COUNTRIES UNTIL AN EMERGENCY IS DECLARED. WHILE S.812 MAKES IT EASIER FOR THE PRESIDENT TO PROHIBIT THESE LOANS, WE MUST ALSO CREATE STANDARDS BY WHICH TO JUDGE SUCH LOANS.

SURELY LOANS FOR MILITARY OR HIGH TECH, SUCH AS COMPUTERS, POLICE SURVEILLANCE EQUIPMENT, ETC., OUGHT TO BE PROHIBITED NOW. MOREOVER, ANY SUCH LOANS SHOULD NEVER BE GUARANTEED BY U.S. TAXPAYERS. AS YOU MAY KNOW, $17 BILLION WORTH OF LOANS TO THE

SOVIET UNION ARE GUARANTEED BY WESTERN GOVERNMENTS (APPENDIX B).

AT LEAST FOUR COMMUNIST COUNTRIES, INCLUDING POLAND, YUGOSLAVIA, CUBA, AND NICARAGUA; HAVE DEFAULTED ON LOANS TO PRIVATE BANKS. THE SOVIET UNION SHOWS NO FEAR IN LETTING THEM DEFAULT. THESE PUPPET GOVERNMENTS POSE SOME OF THE GRAVEST RISKS TO THE UNITED STATES AND ITS ALLIES BY SERVING AS BASES FOR ESPIONAGE AND AGGRESSION AGAINST THEIR NEIGHBORS, WHILE CRUSHING THE HUMAN RIGHTS OF THEIR PEOPLE.

2) LOANS TO COMMUNIST GOVERNMENTS ARE USED TO ASSIST OTHER COMMUNIST COUNTRIES IN GLOBAL POLITICAL ACTIONS.

THE RECENT LOANS TO EAST GERMANY OF FIRST $500 MILLION AND THEN $600 MILLION ARE A CLASSIC EXAMPLE OF HOW THE MONEY SPILLS OVER TO OTHER COMMUNIST DICTATORS. SUBSEQUENTLY, $84 MILLION IN CASH AND CREDITS WERE EXTENDED TO THE COMMUNIST GOVERNMENT OF NICARAGUA. NICARAGUA RECEIVED CASH, TRADE, AND TRAINING FROM EAST GERMANY FOR THEIR MARXIST REGIME. MEANWHILE EAST GERMANY HAD $5 BILLION DOLLARS IN CASH RESERVES IN THE BANK (APPENDIX G).

WE INVITE YOU TO DRAW YOUR OWN CONCLUSIONS. WHAT MAKES THIS EPISODE EVEN MORE TROUBLING WAS THAT THE U.S. AMBASSADOR, ROZANNE RIDGEWAY, SENT TWO EAST GERMAN REFUGEES, DR. AND MRS. BERNARD SCHNAPPAUF BACK INTO EAST GERMANY'S HANDS. APPARENTLY

AMBASSADOR RIDGEWAY THREW THEM OUT OF THE EMBASSY SO THAT THE EAST GERMANS WOULD NOT HAVE ANY "CONFLICT" THAT COULD INTERFERE WITH THE PENDING DISCUSSIONS OVER THEIR LOAN FROM WESTERN BANKS. IMAGINE, IF WE HADN'T GIVEN EAST GERMANY THEIR FREEDOM-SEEKING DEFECTORS, THEY MIGHT HAVE GOTTEN MAD AND REFUSED THE LOAN. THE DAMAGING IMPACT OF OUR BANKS ON OUR PRINCIPLES IS TROUBLING. FOR EXAMPLE, THE WEST GERMAN BANKS HAVE USUALLY RECEIVED HUMAN RIGHTS CONCESSIONS FROM EAST GERMANY. IN THIS CASE, OUR OFFICIALS ARE MAKING CONCESSIONS TO HUMAN RIGHTS VIOLATIONS WHEN U.S. BANKS LOAN MONEY WITH NO STRINGS ATTACHED. THE TIME FOR REGULATORY REVIEW HAS COME.

3) COMMUNIST REGIMES HAVE A RECORD OF MANIPULATING THEIR BALANCE SHEETS, TO CREATE THE FALSE IMPRESSION THAT THEY ARE CREDIT WORTHY.

TAKE THE CASE OF THE TOP SECRET DOCUMENTS CONFISCATED IN THE GRENADA LIBERATION. ONCE AGAIN, WE CAN READ COMMUNIST ECONOMIC OBJECTIVES IN THEIR OWN SECRET DOCUMENTS. THE DOCUMENTS, CONFISCATED BY U.S. TROOPS, SHOW THAT GRENADA'S ECONOMIC SITUATION WAS DESPERATE. MONEY WAS URGENTLY NEEDED. GRENADA SOUGHT IMF LOANS FOR "SOCIO-ECONOMIC" ASSISTANCE WHILE IT CONSTRUCTED A MILITARY AIRPORT WITH PART OF THE MONEY. GRENADA DID NOT INTEND TO SPEND IMF LOANS TO IMPROVE ITS ECONOMIC STATUS. THE "INTERNATIONAL AIRPORT" WAS A "COMMERCIAL" FRONT FOR WHAT WAS IN FACT A MILITARY AIR-FIELD.

THE IMF MAY HAVE HOPED TO PREVENT SUCH MISDEEDS BY IMPOSING RESTRICTIONS ON GRENADA'S LOANS. GRENADA HOWEVER, DID NOT INTEND TO ABIDE BY SUCH RESTRICTIONS. THEY DID NOT INTEND TO PAY BACK THEIR LOANS NOR USE THEM TO UPGRADE GRENADA'S SINKING ECONOMY. IT IS EVIDENT FROM THE CAPTURED GRENADA DOCUMENTS THAT MAURICE BISHOP UNDERSTOOD THE SETBACK AN IMF EVALUATION WOULD IMPOSE ON THE 'REVOLUTION,' AND THE NEED TO OBSCURE THESE FACTS FROM THE IMF TO PREVENT SUCH AN EVALUATION.

GRENADA DECIDED TO FRAUDULENTLY ADJUST THEIR FIGURES TO CONFUSE THE IMF. FOR EXAMPLE, "MAURICE BISHOP SUGGESTED THAT WE USE THE SURINAME AND CUBAN EXPERIENCE IN KEEPING TWO SETS OF RECORDS IN THE BANKS FOR THIS PURPOSE" (APPENDIX F).

BASED ON GRENADA'S PHONY SET OF BOOKS, THE INTERNATIONAL MONETARY FUND APPROVED $14.1 MILLION IN LOANS TO THE COMMUNIST GOVERNMENT OF GRENADA. THIS LOAN WAS RESCINDED AFTER THE U.S. LIBERATION, BUT THE INCIDENT SHOWS HOW DANGEROUSLY EASY IT IS FOR COMMUNIST COUNTRIES TO RECEIVE UNREGULATED LOANS WHICH THEY USE TO PERPETRATE OPPRESSION.

THE SAME DOCUMENTS SHOW THE SOVIETS WERE PULLING THE STRINGS IN GRENADA. THUS, IT SHOULD SURPRISE NO ONE IF THE PUPPET MASTER ACTS IN THE SAME WAY AS HIS PUPPETS. RECENTLY, THE SOVIET UNION BORROWED $200 MILLION FROM FIRST CHICAGO. IN 1984, A CONSORTIUM OF 31 WESTERN BANKS ANNOUNCED A LOAN OF $250 MILLION. THE SOVIET

UNION IS PRESENTLY CARRYING ON A BRUTAL WAR ON A CIVILIAN POPULATION AND HAVE COMMITTED HEINOUS MASS MURDERS REMINISCENT OF ADOLPH HITLER. THEY HAVE KILLED ONE MILLION AFGHAN MEN, WOMEN AND CHILDREN AND ARE PREPARED TO KILL MORE. THE SOVIETS ARE ALSO FUNDING TERRORISTS IN MANY PARTS OF THE WORLD WHICH ATTACK THIS COUNTRY'S MILITARY BASES, ALLIES, AND THE FREE PEOPLE OF OTHER COUNTRIES.

THE SOVIETS MAINTAIN A HUGE FORCE OF INTERNAL SPIES TO TERRORIZE THEIR OWN PEOPLE, AND ITS PRESENT DICTATOR, GORBACHEV, ROSE TO POWER WITH THE HELP OF THE KGB. THE KGB HAS BECOME THE SINGLE GREATEST POLITICAL FORCE IN THE SOVIET UNION TODAY, AND IS IN CLEAR COMMAND OF ITS GOVERNMENT. SO WHEN YOU SEE A U.S. BANK LOANING THE SOVIETS $200 MILLION, YOU WILL UNDERSTAND OUR ALARM.

AT THE SAME TIME THESE ATROCITIES ARE TAKING PLACE, THE SOVIET UNION'S OWN ECONOMY IS CHRONICALLY ILL BECAUSE OF INEFFICIENT COMMUNIST PARTY PLANNING AND RELIANCE ON SLAVE LABOR, WHILE IT POURS TWICE AS LARGE A PERCENTAGE OF ITS BUDGET AS WE DO INTO MILITARY ARSENALS.

CLEARLY SUCH LOANS IMPINGE ON THE FOREIGN POLICY POWERS OF THE PRESIDENT AND THE CONGRESS. TO TAKE FEDERALLY INSURED DEPOSITS AND LOAN THEM TO THE SOVIETS WITHOUT MAKING THEM ACCOUNTABLE FOR THE USE OF THOSE LOANS NOR IMPOSING LIMITATIONS

STRIKES OUR MEMBERS AS HIGHLY QUESTIONABLE.

IT SEEMS TO US TO BE SHEER INSANITY FOR THE U.S. TO PERMIT LOANS TO THE SOVIET UNION WHICH ALLOW THEM TO DIRECT OTHER RESOURCES INTO NUCLEAR MISSILES AIMED AT THIS CITY. THIS THEN REQUIRES US TO CATCH UP BY INCREASING OUR MILITARY BUDGETS, ALL IN THE FACE OF HUGE DEFICITS WHICH THREATEN THE VERY FOUNDATIONS OF OUR ECONOMY.

NEITHER THE EXPORT ADMINISTRATION ACT NOR ANY OTHER LAW CONTAINS SUFFICIENT DIRECTIVES PREVENTING QUESTIONABLE INTERNATIONAL LOANS FROM ENDANGERING OUR NATIONAL SECURITY AND ECONOMY. THE PRESENT INTERNATIONAL EMERGENCY ECONOMIC POWERS ACT DOES OFFER ECONOMIC PROTECTION, BUT IT CAN ONLY BE EXERCISED BY THE PRESIDENT IN EMERGENCY SITUATIONS. IT IS BETTER TO PREVENT AN INTERNATIONAL EMERGENCY THAN TO HAVE TO LATER COPE WITH THE RESULTS OF ONE. S. 812 GIVES AUTHORITY TO THE PRESIDENT TO HELP PREVENT LOANS OF THIS KIND FROM REACHING CRISIS LEVELS. THEREFORE I WOULD URGE YOU TO STRENGTHEN THIS BILL BY REQUIRING THE PRESIDENT TO ELIMINATE ALL LOANS TO COMMUNIST COUNTRIES FOR TECHNICAL, HIGH TECH, AND MILITARY PURPOSES.

THE FLOW OF INVESTMENT AND CAPITAL ACROSS NATIONAL BORDERS SHOULD IN PRINCIPLE BE FREE AND UNRESTRICTED, BUT SUCH A POLICY SHOULD NOT INCLUDE THE SOVIET UNION BECAUSE OF THE RESULTING HARDSHIPS SUFFERED BY THE UNITED STATES IN TERMS OF DEFICITS AND

THE COMPETITION FOR CAPITAL ELSEWHERE IN OUR ECONOMY. I WOULD URGE YOU TO FOCUS YOUR ATTENTION ON THE FOLLY OF SUCH LENDING TO THE USSR. CURRENTLY THE TOTAL DEBT OWED TO THE WEST BY THE SOVIETS IS $28.8 BILLION (APPENDIX B). IN FACT, 61 PERCENT OF THE TOTAL OUTSTANDING LOANS TO THE USSR, OR $17.67 BILLION, ARE GUARANTEED BY WESTERN GOVERNMENTS. THIS MEANS THAT THE RISKS OF WESTERN BANKS AND BUSINESSES DOING BUSINESS WITH THE SOVIET UNION ARE REDUCED SIGNIFICANTLY BY GOVERNMENT LOAN GUARANTEES. WE AND OUR ALLIES ARE INDIRECTLY SUBSIDIZING THEIR SUBVERSION, TERRORISM AND MILITARY BUILDUP. A VISITOR FROM ANOTHER PLANET WOULD PRONOUNCE US CRAZY.

THIS 61% REPRESENTS A MUCH HIGHER PERCENTAGE OF LOAN GUARANTEES THAN BRAZIL, MEXICO, OR ARGENTINA HAVE. THEIR RESPECTIVE PERCENTAGES OF GUARANTEED LOANS IS 19%, 10%, AND 15%. POLAND, IN KEEPING WITH THE SOVIET PATTERN, HAS THE SECOND HIGHEST PERCENT OF GOVERNMENT GUARANTEED LOANS AT 38%.

PRESENTLY SEVERAL COMMUNIST GOVERNMENTS WHO ARE BORROWERS ARE IN DEFAULT (APPENDIX G). BUT THEY ARE BEING GIVEN GRACE PERIOD AFTER GRACE PERIOD WITHOUT ANY REPAYMENT PENALTIES.

THE FOLLOWING CHART SHOWS HOW MUCH THESE COUNTRIES OWE PRIVATE LENDERS, AND HOW MANY YEARS GRACE THE BANKS HAVE GIVEN THESE BORROWERS:

COUNTRY	TOTAL DEBT AMOUNT	YEARS GRACE
CUBA	$2.9 BILLION	2-5
NICARAGUA	$4.0 BILLION	4-7
POLAND	$23.8 BILLION	4-5
RUMANIA	$8.6 BILLION	3
YUGOSLAVIA	$19.0 BILLION	3-5

DON'T OUR FARMERS DESERVE AT LEAST AS LONG A GRACE PERIOD ON THEIR LOANS AS COMMUNIST CUBA?

WHILE COMMUNIST GOVERNMENTS RECEIVE BILLIONS OF AMERICAN DOLLARS AND DEMAND EXTRAORDINARILY LONG GRACE PERIODS FOR REPAYMENT BY THREATENING TO REVOKE THE PROMISE TO REPAY ALTOGETHER, AMERICANS ARE PAYING HISTORICALLY HIGH RATES, FARMS ARE BEING REPOSSESSED, AND BANKS ARE FAILING. AMERICA HAS REACHED A CRITICAL JUNCTURE WHERE SHE CANNOT AFFORD SUCH ABUSES. THESE LOANS UNDERMINE OUR NATIONAL SECURITY, DESTROY THE AUTHORITY OF THE PRESIDENT TO CONDUCT FOREIGN POLICY AND FINANCE OUTLAW DICTATORS.

I FIND IT IRONIC AND HYPOCRITICAL TO PRESS FOR SANCTIONS AGAINST SOUTH AFRICA WHILE PERMITTING LOANS TO THE SECOND LARGEST GOLD PRODUCER, THE SOVIET UNION. AT LEAST IN SOUTH AFRICA, MINERS COME AND WORK VOLUNTARILY WHILE MINES IN THE SOVIET UNION ARE MINED BY SLAVE LABORERS.

I URGE YOU TO INCREASE THE POWER OF THE PRESIDENT TO EXERCISE HIS CONTROL UNDER THE EXPORT ADMINISTRATION ACT, TO PREVENT COMMUNIST COUNTRIES FROM RECEIVING ANY MORE UNREGULATED LOANS. THE FOREIGN POLICY OF THIS COUNTRY OUGHT NOT BE UNDERMINED BY SUCH GREED. THE NATIONAL INTEREST DEMANDS GREATER CONTROL, GREATER ACCOUNTABILITY, AND HIGHER STANDARDS OF CONDUCT.

THANK YOU.

APPENDIX A

TABLE IN APPENDIX A SHOWS PERCENT OF EXCESS PROBLEM LOANS IN "MONEY CENTER" BANKS TO THE TOTAL EQUITY OF THESE BANKS

Holding company name	Total assets	Total liabilities	Total equity	Excess problem loans to equity	Excess problem loans to equity (percent)	Total foreign loans	Total foreign problem loans	Foreign problem loans to foreign loans (percent)
Citicorp	$135,204,154,000	$127,468,608,000	$7,735,546,000	$1,964,055,129	25.39	$45,823,000,000	$1,990,000,000	4.34
Bankamerica Corp	113,325,883,000	108,302,020,000	5,023,863,000	3,367,997,755	67.04	24,992,042,000	1,346,236,000	5.39
Chase Manhattan Corp	86,001,494,000	81,297,020,000	4,704,474,000	1,743,478,064	37.06	31,353,470,000	1,720,612,000	5.49
J.P. Morgan & Co., Inc	66,234,578,000	62,797,490,000	3,437,088,000	368,799,542	10.73	19,811,575,000	750,405,000	3.79
Manufacturers Hanover Corp	58,373,114,000	55,751,579,000	2,621,535,000	1,137,484,037	43.39	20,034,688,000	931,446,000	4.65
Chemical New York Corp	57,248,382,000	54,520,671,000	2,727,711,000	873,140,291	32.01	14,131,391,000	632,961,000	4.48
Bankers Trust New York Corp	45,290,512,000	43,292,824,000	1,997,688,000	351,193,550	17.58	10,759,645,000	367,969,000	3.42
First Interstate Bancorp	43,045,532,000	40,544,729,000	2,500,803,000	567,432,200	22.69	3,010,321,000	177,262,000	5.89
First Chicago Corp	39,639,355,000	37,931,040,000	1,708,315,000	466,369,995	27.30	7,748,208,000	301,080,000	3.89
Security Pacific Corp	39,147,559,000	37,388,624,000	1,758,935,000	830,745,000	47.23	4,929,292,000	392,336,000	7.96

APPENDIX B

[Article in Wall Street Journal, May 14, 1984, indicates amounts of loans guaranteed to Soviet Union by U.S. taxpayers.]

SUBSIDIZING THE SOVIETS

A group of West European banks last week brushed aside all memories of sick Polish loans and cheerfully had another go at the roulette wheel with a new $250 million loan to the Soviet Union. The Eurobanks would have happily forked over $300 million had not the Russians said, "Oh no, please, that's too much." We're happy to report that American banks chose not to play, proving that they have learned a few things.

The latest European plunge eastward coincided with some other news. In a joint report, the Organization for Economic Cooperation and Development (OECD) in Paris and the Bank for International Settlements (BIS) in Basel revealed that the Soviets already owed the West more than $28.7 billion, as of last June. That is twice as much as previous estimates, which did not combine private and government loans. And it almost certainly understates the total current Soviet hard-currency debt, which by all accounts is up from last June. Banking circles also believe that Moscow Narodny Bank's West European branches have a large net borrower position in the short-term "interbank" market.

But even without further growth, the $28.7 billion made the Soviet Union the third-largest hard currency debtor in the world, behind Brazil and Mexico. More startingly (see table), it ranked first in the world in loans subsidized by Western governments, a total of $17.67 billion.

[In millions]

	Total debt owed to the West	Part of the total subsidized by Western taxpayers	Proportion of the total subsidized by Western taxpayers
1. Brazil	$66,998	$12,494	19
2. Mexico	65,090	6,667	10
3. U.S.S.R	28,772	17,671	61
4. Argentina	26,367	3,953	15
5. Spain	25,295	3,198	13
6. Venezuela	24,221	1,805	7
7. South Korea	24,000	7,039	29
8. South Africa	16,828	4,286	26
9. Poland	15,897	6,000	38
10. East Germany	(?)	(?)	(?)

The figures in the table are not all-inclusive. IMF loans are excluded. And East German debt figures are incomplete because the West Germans describe some of it as "inter-German" lending, conveniently ignoring the well-known no man's land that separates the two Germanies. In short, the total West-to-East subsidy is underestimated.

The Soviet subsidy loan level, never before acknowledged by the lending countries raises an interesting question for Europe's political and business leaders: When did taxpayers in the lending countries ever decide to subsidize communism?

Of the $17.67 billion, $5.8 billion is bank loans guaranteed or insured by governments and $11.8 billion is direct credits backed by governments to Western exporters of goods "sold" to the Soviets. Those quotation marks symbolize the hocus-pocus of East-West. When loans to Brazil, Argentina and the like go sour, private bankers are at least forced to lose a little sleep until the IMF or central banks bail them out. But in lending to the communists, their bailout is up front in the form of guarantees. No wonder they can be so cheerful.

Two reasons can be offered for the Western generosity to the Soviets. As someone once noted, the Russians are like the Pentagon. They don't trade, they procure, and in huge amounts. Western businessmen and politicians simply can't resist those big deals. Since taxpayers aren't readily aware that they are providing the subsidies, who worries? The second reason is that Western politicians mistakenly believe that credit generosity is a way of appeasing Soviet warlords.

President Reagan, pressing his disfavor over the Siberian pipeline deal, has tried to lift OECD standards for loans to the Soviets. But European banks, businesses and politicians still are answering the siren call. They choose not to trouble themselves with the important fact that the Soviet Union, as an economic cripple, has little to trade in return, except the privilege of becoming dependent on Soviet energy. That fact has economic importance. One-sided trading is a sure route for the Soviets to the debt-restructuring line, and when they request the favor, the Europeans are not likely to refuse. At that point, the transfer of resources from West Europe to the Soviet people will grow even larger.

American bankers last week decided that it was time to draw a line. We wonder how much more the Europeans will want to contribute to the Soviet empire before they reach the same conclusion.

APPENDIX C

GRENADA DOCUMENTS: MAURICE BISHOP EXPLAINS HOW GRENADA WILL FAIL ANY TEST OF ITS ECONOMIC FIGURES, FORCING IMF TO HOLD BACK ANY LOAN TO GRENADA

Grenada Documents. August Political Bureau meeting, pp. 3. "Cde.[1] Bishop said that the document summarizes all aspects of the dealings with IMF negotiations. It also shows how the money will be allocated. Out of the $39 million only 9.7 will be spent by Central Government over the 3 year period. The first draw down is expected to arrive today. The document is quite an important document which requires study by P.B. (Political Bureau) and C.C. (Central Committee) members. It shows that we will fail the test in the second quarter. A number of corrective measures were suggested including tighter control on capital investment project spending in the second quarter. The objectives of the different state enterprises must be made clear and the immediate recommencement of the meetings of party monitoring of the economy. The P.B. gave the C.C. the test to organize for the resumption of the meetings."

APPENDIX D

GRENADA DOCUMENTS: REGARDING A DRAFTED AGREEMENT BETWEEN GRENADA AND IMF. GREAT CONCERN EXISTS OVER A PARAGRAPH ON "THE EVALUATON" BY IMF, AND THE POLITICAL BUREAU DECIDES TO FORMULATE A NEW AGREEMENT

Grenada Documents. August 1983 Political Bureau meeting, pp. 3. "Cde. Barnard La Cobinere said the IMF staff told him that the Managing Proctor had approved their draft and so they were pressing him for us to approve that draft for circulation. Cde. Bishop raised serious concerns about the paragraph on the evaluation. He said that he had no objection with the first sentence but felt that acceptance of the whole paragraph would be very bad for us in the region. A new formulation had to be worked out. He suggested that Dick Hart and Dave Bodhoo be called in to assist in the formulation. Cde. Mirton said that the most difficult aspect of the programme was how to ensure that quarterly and annual sealing of the public sector in order to pass these tests."

APPENDIX E

GRENADA DOCUMENTS: GRENADA DECIDES TO KEEP TWO SETS OF ACCOUNTING BOOKS IN ORDER TO ADJUST THEIR ECONOMIC FIGURES AND GET THE NECESSARY LOAN FROM IMF

Grenada Documents. August meeting of Political Bureau pp. 7. "It was also noted that 14.2 million will be paid to the IMF for loans.

"Cde. La Cobinere said that the government will have to be very tight in the first and second quarter to ensure reasonable leeway in the other quarter.

"Failure means a renegotiation of the programme and holding back the money by IMF.

"The average says that a total of 8 million must be made. The Cdes. also said that the report from the state enterprises is very important when IMF comes down next year. To ensure that these reports are done the monthly session on the economy must be reconvened immediately.

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[1] Cdes. = Commandantes.

"Cdes. said that the month of July was bad however the upcoming months would be better.

"Pre programme year figures must be made available to the IMF. Cdes. again highlighted the urgent importance of training Cdes. to adjust the banking figures. Someone should be sent to Cuba or Suriname."

APPENDIX F

The table in Appendix F shows the total monies loaned to communist countries from commercial banks, the rescheduling dates, and the number of grace years before pay-back begins.

Africa, Far Eastern and European Countries

Latin American, North American and Caribbean Countries

Summary of Terms and Conditions of Sovereign Debt Reschedulings with Commercial Banks

1982 to the Present

Country (Total External Debt Outstanding)	Date of Agreement(1)	Amount(2)		Repayment (3)		Spreads		Fees	
				Grace	Final Maturity	LIBOR	Prime	Type	%
Cuba ($2.8b)	December 1982	• Rescheduling - Long-term (9/1/82-9/1/83) - Short-term (2/1/83 - 9/1/83)	130m 371m	2 1/2	7	2 1/4 1 1/4		Rescheduling Rescheduling	1 1/4 1/4
	December 1984	• Rescheduling - Long-term (1/1/84 - 12/31/85) - Short-term (9/1/84 - 9/1/85)	100m 371m	5	9	1 7/8 1 3/4		Rescheduling Facility	7/8 1/4
Nicaragua ($4.0b)	March 1982	• Rescheduling	$ 160m(5)	1 1/2 - 4 1/2	10	3/4(9)			
	February 1984	• Rescheduling (3/1/83-3/1/84) • New Money	143m 93m	3	8 6	1 1/4 - 1 3/4(10) 2 1/4	2 1/8		
	June 1985	• Deferral (6/30/84-6/30/86)	309m(11)			1 1/4(12)			
Poland ($23.8b)	April 1982	• Rescheduling (95% of 3/1/81-12/31/82)	1.9b	4	7	1 3/4			
	November 1982	• Rescheduling (95% of 1/1/82-12/31/82) • Revolving Trade Credit	2.2b 374m	4	7 3	1 3/4 1 1/2		Rescheduling Facility	1 1
	November 1983	• Rescheduling (95% of 1/1/83-12/31/83) (65% of interest 1/1/83- 12/31/83)	1.1b 174m	5	10 5	1 7/8(6) 1 3/4		Rescheduling	1
	July 1984 May 1984	• Rescheduling (95% of 1/1/84-12/31/87) • New Money (6 month revolving trade facility)(8)	1.6b(7) 630m	5	10 5	1 3/4 1 5/8		Rescheduling Facility	1 1/2
Romania ($8.6b)	August 1982	• Rescheduling (80% of arrears as at 12/31/81 + principal 1/1/82-12/31/82)	$ 1.3b	3 years	6 1/2 years	1 3/4%		Rescheduling	1%
	June 1983	• Rescheduling (70% of 1/1/83-12/31/83)	602m(4)	3	6 1/2	1 3/4		Rescheduling	1
	May 1985	• Bridging Loan	80m		2-3				
	In Process	• Bridging Loan	150m						
Yugoslavia ($19.8b)	September 1983	• Rescheduling-Short-term (1/1/83-12/31/83) -Medium-term (1/18/83-12/31/83) • New Money	600m 1.0b 600m	3 3 3	2 6 7	1 3/8 1 7/8	1 1/4 1 3/4	Rescheduling Rescheduling Facility	1/4 1 1/8 1 1/8
	June 1984	• Rescheduling (1/1/84-12/31/84)	1.245b	4	7	1 5/8	1 1/2	Rescheduling	7/8
	In Process	• Rescheduling (90% of 1/1/85-12/31/85 + 100% of 1/1/86-12/31/88)	3.5b	5	10	1 1/4	1		

APPENDIX G

[Wall Street Journal, June 19, 1985, explains how Poland borrows from the United States and then lends to the Soviet Union]

Poland Gives Credit Where It's Due: To Russia

(By Zdzislaw M. Rurarz)

As almost everybody knows by now, Poland's economy is in terrible shape, sending Gen. Wojciech Jaruzelski scrambling for Western credits. Just last week, in fact, the general met with the Japanese foreign minister, and his angling for credits through the International Monetary Fund has been given much coverage.

But there is one development that has gone virtually unreported: Polish credits to the U.S.S.R. That Poland is heavily indebted to the West, to the tune of $27 billion to $28 billion, is no secret. Nor is its indebtedness to the Soviet Union, about $5 billion.

For obvious reasons, given the situation of present day Poland, anything even resembling a credit extended by that country to the U.S.S.R. could never have been announced. That is why Polish official sources make oblique references to the event, though not all the details are officially known.

What does appear certain right now is that Poland is to provide the U.S.S.R. with credits amounting to about 900 billion zlotys over the years 1986 to 2000. What this translates to in dollars is difficult to say, because one of the quirks of the artificially set currencies of the U.S.S.R. and its Eastern European satellites is that it costs more to buy U.S. dollars with Polish zlotys than it does with Russian rubles. But a reasonable estimate would put these credits' real worth at about $10 billion.

On the other details, the only known fact is that the Polish credits will go toward three projects; the construction of the gas pipeline from Kobryn and Brest in the Soviet Union to Warsaw, the Yamburg gas pipeline, and a coal-gasification plant in the U.S.S.R. It also appears that apart from material deliveries, Polish specialists and workers would be used in those projects within the credit terms.

This is extremely bad news for Poland. It appears that Polish planners themselves were surprised by the credits under consideration. For this reason, these credits to the U.S.S.R were not originally included in Poland's future 5-year plans.

The credits to the Soviets also come at a time when Poland—after several years that saw the level of investments fall sharply—is scheduled to increase the level of investments through the end of this century. In the energy field alone, such investments are to increase eightfold, with overall investments increasing at a rate not much below this—excessive, according to most Polish experts. Under the best of conditions—Poland's yearly growth in gross national product on a per-capita basis may be no more than 2.5 percent.

Even more disturbing is the fact that Poland's terms of trade with the U.S.S.R. continue to work to the Soviets advantage. This is because the price of imported Soviet oil is only now catching up with its world level of a few years ago, when world oil prices had peaked. According to the odd price system used within the Council for Mutual Economic Assistance, the price of Soviet oil is taken from the average of world prices from the preceding 5 years; hence the benefit to the Soviets now.

In any case, within Polish Soviet economic relations this development represents a sharp reversal of the practices of the recent past, when beginning in 1980 the U.S.S.R. provided Poland with credits. Not only is this era over, but the roles have now reversed.

It is still unclear why the Soviets have opted for this change. Certainly there are purely economic motives: Simply to maintain the present level of oil extraction in the U.S.S.R. means a great increase in costs. The Soviets quite recently have also been rather frank with their satellites, telling them that if they wish to maintain their level of energy imports from the U.S.S.R. they must participate in various credit investments."

Yet the Soviets are not blind to the fact that Poland is in particularly bad shape economically and that any new burdens absent an inflow of fresh credits from the West, the IMF or the World Bank may lead to serious social tensions.

Still, it is quite likely that the Soviets believe the Polish regime has learned how to behave in tense situations. They may even want the Polish authorities to learn yet harsher measures to deal with various upheavals. In fact, the Polish regime—whoever its head would be—really has no alternatives.

Anything like Polish credits for the U.S.S.R. which probably would be tolerated under normal Polish-Soviet conditions, will today be seen by the Poles as the cause of all their country's woes. Understandably, then, the Jaruzelski regime is not eager to say anything openly about these credits. But this silence carries the risk that there will be an even more hostile reaction from the public once it learns about the agreement. This in turn may lead to some developments that may take both the Soviet and Polish regimes by surprise, something not uncommon in Poland's troubed postwar history.

[From the Wall Street Journal, Mar. 19, 1985]

EAST GERMANS BENEFIT FROM U.S. BANK CREDITS THAT DON'T CALL FOR HUMAN-RIGHTS CONCESSIONS

(By Frederick Kempe)

EAST BERLIN—American bankers' eager resumption of credits to East Germany is helping the country avoid human rights concessions in its financial relationship with West Germany.

East Germany avoided a Polish-like financial crisis in 1982 and 1983 through two separate credits negotiated and guaranteed by Bonn and extended by West German banks. In return, East Germany eased restrictions on West German visits to the East, and it also last year allowed 40,000 East Germans to emigrate to West Germany.

Western experts now believe that East Germany yielded the short-term human-rights concessions to pursue significant longer-term aims that would spare it from such a vulnerable political position again. It combined the West German credits with a strict austerity program and dramatic import reductions to considerably improve its economic performance and its image among international creditors, who now are competing to give the country money.

CHANGE OF COURSE

Bank of America, Manufacturers Hanover, and Citicorp, who were refusing East Germany new credits a little more than a year ago, are managing with the Bank of Tokyo a $150 million credit that has grown to $500 million largely due to U.S. banks' demand. The loan hasn't any political strings attached, and its terms are the best East Germany has seen since the Polish repayment crisis—7/8 percentage point over the London Interbank Offered Rate (LIBOR) or an option for 1/2 percentage point over the U.S. prime rate. It is to be repaid over 7 years with a 3 year grace.

"It's all a political business," says Wolfgang Seiffert, economic adviser to the East German government until 1978, and now a professor in Kiel, West Germany. "The attempt of East Germany to get money from American and other banks is an effort to get western finances without liberalization measures. The money will give East Berlin a stronger hand for its political games with West Germany because it doesn't need Bonn's money as much anymore."

West German bankers also complain that the Americans have been driving prices down in their effort to get back into the East German lending market that they abandoned in 1981, when Poland cast a shadow over all of Eastern Europe.

Until last year, West Germany banks were extending the East Germans primarily commercial loans, usually to be repaid after one year at a rate three to four percentage points above LIBOR. However, East Germany extracted far better conditions from First National Bank of Chicago when it worked its way back into the market last year. First Chicago offered a $75 million club loan at only one percentage point above LIBOR, a rate that European banks thereafter were forced to match despite a feeling by many lending officers that the margin wasn't sufficient.

THE GROWING GAP

U.S. banks are injecting money into the East German economy at a critical time. East Germany considerably reduced imports over the past 3 years to achieve hard currency trade surpluses and to service debts, but it also dangerously reduced investment. The result was that the technology gap between it and its West European neighbors grew.

Western economists expect the next East German 5-year plan, from 1986-90, to include an ambitious investment program, particularly emphasizing purchases of Western technology.

This is partially a response to a Soviet ultimatum that Moscow is to get Western quality goods in exchange for the raw materials it provides Eastern Europe, or

Moscow will reduce the amounts provided. The Soviets warn that Soviet oil can simply be sold on Western markets and the proceeds used to buy more advanced Western products.

"The East Germans are the largest East European technology sluice and supplier for the Soviets," says Klaus Schroeder of the West German government-sponsored Institute for Science and Policy near Munich. "Soviet demands have put a large amount of pressure on the East Germans to modernize their industry."

GOOD PERFORMANCE

U.S. bankers argue that they have good reason to be wooing the East Germans. First, they say East Germany's economic performance is the best in Eastern Europe. Produced national income (basically, gross national product minus invoices) in 1984 rose by 5.5%, compared to 4.4% the year before. Net industrial production rose 8.5% against 4.6% in 1983. Industrial labor productivity increased 7.7% against 5.8% in 1983.

The bankers also cite a radical improvement in East Germany's external position. While East Germany's debt to Western banks of $10 billion once was worrying to the banks, they have placed more emphasis on East Germany's buildup of deposits in Western banks to some $4.5 billion.

Some also argue that a double umbrella exists over East Germany. They say the Soviets wouldn't allow their most important economic ally to enter into repayment difficulties and hence would bail the East German out. The bankers are even more confident about a West German umbrella, following Bonn's financial intercession during East Germany's recent problems.

"The proof is in the pudding," one U.S. banker says. "East Germany is a solid bet. We have been aggressively adding to our exposure."

However, many Western experts believe the banks are making the sorts of errors they did when more than 400 lending institutions scrambled in the 1970's to do Polish business. They are competing to give East Germany even more cash than it is asking for, yet East Germany economic reporting remains inprecise. The bankers haven't any specific idea what East Germany intends to do with all the money, nor whether it can eventually earn the hard currency to repay the loans.

"Bankers learn very slowly and forget very quickly," says Mr. Schroeder, a former bank economist.

Says Mr. Seiffert, "The economic situation in East Germany has improved, and so no one should have great worries about giving the country credits, but the U.S. banks currently aren't being prudent enough and should only extend credits when linking them to specific projects or investment plans."

The CHAIRMAN. Thank you, Mr. Ruff.

Mr. Rurarz, you testified before this committee in February 1982, at our hearings on the Polish debt. I ask you the same question I asked Mr. Allen: What has changed since then that we should be making loans to these Eastern bloc countries? Is there anything that you see that's different in their activities or behavior since you testified before?

EASTERN BLOC COUNTRIES ARE SUBSIDIZING U.S.S.R.

Mr. RURARZ. Not at all. I think the change is for the worse. To give an example, ever since that time the so-called economic and military integration among the Soviet bloc countries has progressed and more is to come and whatever is offered to any of the Warsaw Pact countries, especially to Eastern Europe, may finally end in the U.S.S.R.

Just to be more specific on that, the U.S.S.R. is inviting let's say half a dozen Eastern European countries to participate in the so-called Joint Investments in the U.S.S.R., especially in the energy sector and elsewhere. What does it mean in fact? It means that Eastern European countries are extending credits to the U.S.S.R., long-term credits with an interest rate of 2 percent only. These credits, moreover, are calculated on a very peculiar basis. I mean, against the so-called Soviet domestic investment costs which have no connection to any international comparisons.

To be more specific, for instance, Poland will be investing in the next 15 years something like 900 billion zlotys in the U.S.S.R. which means only 2 billion transferable rubles which means the exchange rate from zlotys to rubles would be something like 450 zlotys while the official exchange rate is 86 zlotys only. So you can imagine, Mr. Chairman, what a heavy subsidization of the Soviet economy is being done by Poland.

So when Poland receives a credit from the West for whatever purposes, it could be related to credit to the U.S.S.R., not saying about some other things which are always distorted.

So this is the change which is a change for the worse because the Soviet Union after the so-called Moscow Comecou Summit last year and even this year in Warsaw is now demanding ever more of such investments in the U.S.S.R. I'm not saying about some other burdens which Eastern Europe must bear. So without any profound change in Eastern European-Soviet Union relations and without any systemic changes in Eastern Europe and in the U.S.S.R. any credits for those countries are a waste of money, especially if no political strings are attached to them. Thank you.

The **CHAIRMAN**. Banks are still not lending to Poland at the current time. They are lending to East Germany on the argument that East Germany's economy is strong and that it's a good credit risk. But, of course, that was the same thing I heard about Poland before Poland got in trouble.

Would you think that East Germany is an example of a better credit risk than Poland?

Mr. **RURARZ**. Oh, no. I think that East Germany is even potentially in a much more difficult situation. Why? Because due to the fact that their productivity of labor is only half of that one in West Germany and East Germany has a problem with manpower—actually the country today has less people than it had in 1945—so that some dramatic improvement in the productivity of labor would have to happen. Recently East Germany was not investing a lot in the economy because of financial constraints, but a part of that organizational change would have to be done, which is not the case. As I have mentioned previously, the country is practicing a very orthodox economic model which cannot be efficient and under any circumstances I would not believe that there is such a dramatic increase in the productivity of labor in East Germany as it is reported.

CLEVER USE OF SHORT-TERM CREDITS

I should like to say that I am very strongly convinced that this $5 billion of East German reserves in Western banks could be a very clever use of short-term credits because usually only long-term and medium-term credits are reported internationally. Short-term credits somehow escape the attention. And in a country which has a centralistic model as East Germany does and certain other East European countries have, one can borrow heavily on short-term credits and somehow try to confuse the world by depositing them as reserves and this creates the impression that they are economically and financially very much successful. This, of course, is a very misleading picture of the situation and I'm afraid that this is precisely what the East Germans are now doing and, unfortunately, what many in the West are buying in good faith.

The CHAIRMAN. Mr. Rurarz, for several years you were in the inner circles of the Polish Government. We hear all of the arguments that you can separate these apolitical loans, civilian economy versus the military economy of the Soviet Union or the Eastern bloc countries, or that the Soviet Union really doesn't utilize their Eastern bloc countries as a conduit for Western capital.

Rather than speculating from the outside on the inside, what was your experience? Do the Soviets use Poland and other countries as conduits for hard currency from the West or do they not, and can you separate in a socialist economy, a civilian economy from the military economy?

Mr. RURARZ. No; to start with the last question, one cannot. Everything is subordinated to the so-called security considerations which means the military as such has the priority.

To my best knowledge, about 15 percent of Polish manufacturing industry is war oriented and of course the economy is much more heavily burdened with the so-called security problems than officially reported. It could be about 15 percent of the GNP and it has a priority I would say. So that this is precisely the problem—by the way, not new, but which persists and nothing is changing in this respect.

May I add that as far as I know now even more emphasis is put on that due to the fact that new generations of weapons will be produced and therefore the Soviet Union when demanding Eastern Europe to modernize means exactly to produce more sophisticated conventional weapons and therefore Eastern Europe will be now again trying to buy know-how in the West or steal it and, of course, buy on credit terms if possible, so that this is to continue on an even bigger scale than before.

SATELLITES ARE MILITARILY AND ECONOMICALLY TIED WITH U.S.S.R.

When it comes to the other question, the situation is this, that due to the fact that all Soviet bloc countries are very much militarily and economically and of course politically and ideologically integrated with the U.S.S.R., whatever comes to Eastern Europe is on its way to the U.S.S.R., as well, whether indirectly or directly.

I know for sure, for instance, that the Soviets were very much interested that Poland would be borrowing heavily in the West in the 1970's. Why? Because the Polish industries are very much linked to the Soviet industries in many cases and Poland could easily get know-how and credit in the West and apart from that, this was an alternitive to economic reforms. Brezhnev believed at that time that the bloc by receiving more credits and know-how from the West could somehow escape the necessary economic reforms. Of course, this led nowhere, but at that time all the Eastern Europe countries, especially Poland, were very much encouraged to do that. In the meantime, of course, a lot of resources has been specifically devoted to quite simply increase the defense capability of those countries and especially this is true of Poland, East Germany, and Czechoslovakia.

The CHAIRMAN. I never cease to be amazed. I have heard your opinions before privately and publicly and nevertheless, despite the fact that you worked inside the Polish Government, were Ambassador to Japan, I will still have witnesses who will sit in that very seat and say that you are wrong and that they are right and they've never even been to Poland or the Soviet Union. We have had witnesses, one defector from the Soviet Union, who had two Hero of the Soviet Union medals for his contributions to science. He was not a minor scientist. And he had worked in the design bureaus. He testified about technology transfer and how it was helping and yet I'll still have people sitting here saying, "No, it doesn't happen that way."

I wish I could understand the naiveness. You should know better than I. Mine are only opinions from what I hear. You lived and worked there. That's why I want to emphasize that again, that position of Ambassador to Japan, a major industrial country, is not a minor post given to someone who is not trusted by their Government. I think your testimony is very important despite the fact that it will be ignored by a lot of people, but not by this Senator.

Mr. Ruff, you're known to be on the conservative side of the political spectrum, as I am, who doesn't like Government interference. And yet I'm proposing a bill that gets Government interference into the private sector of commercial lending and you're not only supporting but you're suggesting it should be stronger.

How do you rationalize your conservative philosophy of nongovernmental interference with supporting a bill which gives the President the authority to say you can't make that loan?

Mr. RUFF. Any principle can be carried to its ridiculous conclusion, including conservatism, Mr. Chairman.

There's an old adage that says:

> If I owe you $10 and can't pay you, you've got me. If I owe you $10 million and can't pay you, I've got you.

And I think that anyone who is an unthinking knee-jerk, anything, whether it's conservative or whatever, without regard to looking at the realities in the world, is really quite foolish.

In my opinion, whether or not you oppose or support this bill, whether any Senator might oppose or support it or any citizen, would not depend upon whether they're a conservative, or liberal, or whatever. I think it would very much depend on whether or not they accept one basic principle—that the Soviet Union is a sworn enemy—that we are spending hundreds of billions of dollars arming ourselves to defend against or to retaliate if they should strike us.

PERSONAL SURVIVAL TRANSCENDS ANY OTHER PRINCIPLE

And when it comes to personal survival, I think that transcends any other principle. For example, I am, as you, opposed to large deficits and obviously in recent years a rapidly growing segment of our national expenditures is in the defense area. Well, as a conservative, I'd like to be able to cut that back. I'd like to be able to see us with reduced deficits.

In my opinion, however, continuing to make loans to these countries to help subsidize their buildup which we have to respond to by spending more money to build up is the exact antithesis of fundamental conservative thought.

I think that to create a situation which makes that worse and worse and which endangers the underpinning of a free society makes whether or not you are a conservative or a liberal quite irrelevant. If this Nation became dominated or became timorous in its international affairs under the threat of a buildup which we had created and then helped to subsidize, we might not have the choice of whether we're conservative or not. I think that transcends every other consideration.

The CHAIRMAN. Banking is obviously a very complex industry, both domestically but even more so internationally, with exchange rates and all of the things we deal with. After nearly 12 years on this committee I don't understand all I would like to about banking. That's for sure.

But how do you think the American people or the farmers out there that are in financial difficulties feel about us making these sorts of loans to foreign countries? They understand that, don't they?

Mr. RUFF. Well, I think I can speak rather authoritatively on that. I'm a publisher of a financial newsletter. People have a toll-free line and call up and they call hundreds of them every day with questions on every issue of not just financial affairs but on national policy, and I can tell you this, that the calls we get where people's attention has been directed to that issue, particularly from the Midwest, from farmers, particularly from farmers recently as the farm crisis is very real, they are infuriated over the issue. And right now, you may not be aware of this—you might be aware if you saw a most striking show produced on "20/20" recently. The American farmer is so disgusted, hurt, and so damaged, not just financially but emotionally by the crisis that he is facing that he has been the subject of radicalization by many very extreme—and I mean really extreme right-wing organizations, somewhere to the right of Ghengis Khan—antisemitic, looking for scapegoats to explain their problem—which is a symptom of the anger which they face over their situation.

And I can tell you this from the calls we've received, that much of this anger is directed at the policies of the U.S. Government in subsidizing foreign borrowers.

If you recall back during the International Monetary Fund fight 2 or 3 years ago, which as I indicated we helped finance and spearhead through Free The Eagle, we received incredible support from American farmers, from people in the Midwest, who helped us in that, who helped rally phone calls and letters. We were able to bring half a million post cards, letters and phone calls which turned something that was a slam-dunk in the House into a 6-month fight. And it was because of the general anger over the subsidizing of foreign borrowers.

Now when you add it to the fact that the Soviet Union isn't just another foreign borrower, but a bad credit risk, who is probably—as has been indicated here and has been indicated in my testimony—cooking the books in order to look creditworthy, and he is losing his farm, there is real anger in the Midwest. And I personally believe it's thoroughly justified.

The **Chairman**. Well, we will hear the case made that one of the reasons we need to do this is because of our trade deficits and particularly that the agricultural sector that we really are exporting in, and that is true. Without the export business in agriculture, they would be in even much greater difficulty.

Despite that and despite the fact that the case will be made, we need to continue to make these loans so we can sell American agricultural products, I doubt that you can convince a farmer about ready to go bankrupt that our banks should be making loans at lower than market rates, give them years of grace period when they're demanding that their loans be recouped immediately or they're out of business, I would suggest the American farmer might like some of those loan terms, feeling that would be much more helpful to them to be treated equally as well as the Soviet Union or the Eastern bloc countries.

Senator Dodd, do you have any questions?

Senator **Dodd**. Thank you, Mr. Chairman, and my apologies to you and to the other witnesses for not being here earlier when the hearing began this morning, and I gather from the testimony of others based on this extension of credit by First Chicago and Citibank, the idea is to give the administration far more control in these matters.

NEED FOR ADMINISTRATION POSITION ON S. 812

I guess the question I have, Mr. Chairman, maybe any of the witnesses would care to comment on it, I'm just curious. I think it sounds like a fairly good idea but I'd like to know where they stood on it and whether or not they're in support of this concept. I don't know if they're going to be here before we mark up so we get some feel from them on it.

The **Chairman**. Whether who will be here?

Senator **Dodd**. The administration, Treasury and others, as to what their feelings are about it. I'd be curious to know what their views are on it.

The **Chairman**. Well, the administration has taken no position. It was interesting, earlier Senator Dixon quoted from a letter from Treasury asking some questions and although not flatly coming out against this bill, I would expect from that letter that they were leading up to that.

Interestingly enough, I have not seen a copy of the letter to me. They asked Richard Allen if he had seen the letter and he said no. I turned to my staff and asked them. We haven't seen it either. I'm going to find out how Senator Dixon got a copy of a letter to me—and that's no aspersion to Senator Dixon—but I do not have the letter from Treasury to me, but officially the administration has not taken a position. But I frankly don't care what the administration thinks about it.

Senator **Dodd**. I wasn't suggesting you care. [Laughter.]

I know you well enough to know that's not a major issue. But I think taking a nonposition, that to me is ducking a bit. If there are some concerns here, as I know you would feel and I certainly would feel, if they've got some concerns about this I think they ought to articulate them. If there's something that we're missing in all of this, I'd like to know what it is. I think just pretending this legislation is not around is ducking and they should have a position.

The CHAIRMAN. I agree, and whatever their position is they should have one.

Senator DODD. If they want to come up here and say, "We have no position." I would just hope that before we did mark it up we would insist that they come up here and explain why they have a no-position view on this. They must have a rationale for that, I presume, at some point. So as I say, I think what you're trying to do here has got some very good points to it and I could very conceivably be a cosponsor—that may kill the bill for you, but I'd like to at least know where they come from on this issue and as I said, the witnesses have some idea, having talked with them—I don't know. Mr. Ruff, you're in fairly close contact with the folks in this administration. Can you explain what the rationale is for a no position on an issue like this which seems rather clear cut on its face?

Mr. RUFF. Well, I think that at this point the no position—incidentally, I would like to join the distinguished ranks of those who don't care what their position is—or should I say rank of those who don't care.

I think that they're playing the same kind of games that all administrations always play. They're going into a summit conference now. They don't want to rock the boat. They don't want to muddy the waters. I find it absolutely inconceivable that the President wouldn't philosophically resonate in harmony with this bill. But, unfortunately, we have seen the President often, for whatever reason, political or national security—I can't see into his mind—take some positions and some ultimate policy positions that are contradictory to his rhetoric and positions he has taken publicly. And perhaps at this point the safest position for the administration is a don't rock the boat philosophy that the chairman talked about earlier today and criticized and with which I completely agree probably will determine their position for at least a while.

Senator DODD. Mr. Rurarz, do you have any comment?

Mr. RURARZ. Well, for obvious reasons, I cannot comment on what the U.S. administration is thinking about, not being a citizen of this country I could not comment on that.

RUSSIANS HAVE VERY METICULOUS PLANS

But may I add something else, that when it comes to the other side, everything that is being done over there is strictly Government or Politboro decided. The other side is facing the Western business and banking community like a kind of guerrilla-like movement where everybody does what everybody believes is right. While the other side has a battle plan, a very meticulous plan and is playing one against the other and I quite simply cannot believe that nobody in the West has thought about coordinating at least to a comparable degree the actions on this part of the fence. I know that there is the CoCom, there is the OECD, there are some other groups, but I don't think anything is that much institutionalized in order to face as an equal partner the other side which is doing whatever it wants, getting money, not repaying, their credits extended elsewhere are subsidized, and so on and so on, and this is hopeless.

And may I say, Senator, you will be shocked that in 1979 some bankers—I don't want to mention publicly the country and the bank—came to Poland with the offer of new credits and I spoke to them that they should be careful because Poland is becoming insolvent and I was afraid that this would be a disaster for the country. They denounced me to the authorities. Instead of being prudent, they said, no, you have a guy who's trying to discourage us.

Senator DODD. Well, on that last point, that could be a generic complaint. We had hearings the other day in the Foreign Relations Committee involving access to Japanese markets and cargo carriers, not passenger carriers, aircraft carriers—Flying Tigers and so forth. And one of the—if you want to consider it a flaw of the system we have in this country is that we don't have highly coordinated activities between the private sector and Government, for very good reasons.

I would hate to think that we might decide for the sake of some immediate return financially that we would want to duplicate even what the Japanese do, and certainly not what a Marxist government does. So it isn't just a question of being socialist or Marxist governments that have highly integrated operations where the private hand knows exactly what the public hand is doing. In fact, they do it together.

That's one of the flaws we have, as I say, in our system that we allow private industry to go off and cut their own deals quite often. So it is a significant difference in our systems, one that we suffer from to some degree, but I for one anyway would be reluctant to want to become so integrated that we jeopardize that very free flow of commerce that the private sector in this country has provided not only great opportunities for wealth for itself but I think for this country at large.

So it's a difficult call, these questions, not so much the question of whether or not you want to be extending credits to Marxist governments, but whether or not you become so integrated in the conduct of private business and industry that you end up crippling one of our great strengths as a nation, and that is our ability to conduct business.

That's why I'm somewhat curious, because in addition to the philosophical East-West argument of the administration that one would assume it would have—and I'm assuming the administration has this point of view—that while you mention the word East Germany to them or the Soviet Union, one would philosophically assume they had a certain reaction to it. Conversely, I think the administration also has been very outspoken on the issue of private enterprise and being unfettered by Government and feels very strongly about that, whether or not we ought to as a matter of policy, because this fact situation is one that can raise the hairs on the backs of people's necks ought to outweigh that other philosophical point of view the administration has.

So I'd like to hear them articulate that kind of distinction, at least as it appears to me.

Mr. RUFF. Mr. Chairman, the free enterprise system is the finest system ever devised by man, most precisely because it was not devised by man. It's evolved in an area of freedom and it is by its nature messy. It always will be. You can't have freedom without a certain amount of messiness. And I would be concerned if we ever reached the point where as a matter of national policy on all international issues we coordinated national policy with private decisions.

That's why at the beginning of my testimony I indicated that I was very uncomfortable philosophically with my position, but I think we all reach a point where we look at the future, we look at our children, we might see our backs to the wall on an issue, which transcends what might be a theoretical position that you would hope would apply in all circumstances. But I don't know of any theoretical position that applies in all circumstances, including this one.

My concern at this point is, if I could just kind of sum up, if it doesn't sound like a rehash—my concern is that if there is one dominant issue that faces us today, it is our survival as a free enterprise society, and I believe it's threatened in two directions. It's threatened first from our own fiscal irresponsibility which hold the seeds of great financial instability which could resolve itself either in runaway inflation or some kind of cracks in the system by which it falls apart. That is tied in with your economic system and with matters of international security. We're threatened both from within and from without. We are our own worst enemies in many instances.

This is one issue which hits both sides. Not only are we threatened from without by subsidizing people who are our sworn enemies, but second, the fiscal decisions that we are making to compensate for that irresponsibility and the money which we have to spend to compensate threatens us from within with deficits which I don't think there's any Member of Congress that doesn't accept the fact that it's not just a theoretical threat but a genuine threat to the survival of the free enterprise system.

Consequently, if you're going to make exceptions to a free trade policy or to a free enterprise policy, they must be very carefully considered. They must be rare. And I like to think of them as rare blue chips which you use very few of. I might only have five in my whole life where I might want to say, all right, forget the theory, we've got to deal with a private issue. And this is one of them that I consider important enough that if I were in a position of authority I would want to expend a blue chip on this issue.

Senator DODD. Thank you very much.

Thank you, Mr. Chairman.

DISPARITY OF LOAN RATES

The CHAIRMAN. Senator Dodd, one of the things we were talking about before you came in that I feel very strongly about, totally beyond the issue of whether we interfere and give the President the authority to possibly prohibit loans of this type, was the issue of the terms of those loans and that it makes no sense nor can I explain in Utah and you can't explain in Connecticut why you make loans to the Soviet Union at 7 and 9 percent and charge American farmers 12, 13 or 14 percent or when we were making loans on the Kamal pipeline the prime was 21.5 percent. At the very least, it gets back into the free enterprise side, treat them the same as any other customer, don't treat them better, don't treat them worse. Treat them at market rates if we're going to make them, which we have not done. Most of the loans that you look at are loans that I'd love to have—I'd love to have a 9-percent loan on my house and if I can't pay it get 2 to 5 years to bring the arrears up and so on, and they're not treating the American farmer quite as well with their problems out there.

Mr. RUFF. If I were a farmer, Mr. Chairman, I'd love to have a 3 to 5 year grace period on my loans right now as we've allowed Cuba to have.

The CHAIRMAN. Yes;. that would be very helpful. Gentlemen, thank you very much for your testimony.

[Response to written questions of Senator Proxmire follows:]

HOWARD J. RUFF CHAIRMAN

Free
the Eagle
CITIZEN'S LOBBY

February 10, 1986

The Honorable William Proxmire
Senate Banking Committee
SD-534
Washington, D.C. 20510

Dear Senator Proxmire:

As President of Free the Eagle, I am responding to the questions in your letter dated November 7, 1985. I appreciate your interest in this subject. If I can be of any further assistance, please do not hesitate to call.

Sincerely,

Neal B. Blair

Neal B. Blair
President

NBB:rjm

214 Massachusetts Avenue, N.E., Suite 560, Washington, D.C. 20002 (202) 547-2122

Q.1. WHAT DO YOU THINK OF THE CLAIM MADE BY OUR BANKS THAT IF WE DON'T MAKE LOANS TO THE SOVIETS AND OTHER EASTERN EUROPEAN COUNTRIES -- EUROPEAN AND JAPANESE BANKS WILL?

A.1. This claim is false. Japanese and European banks look heavily toward U.S. loan policy. For example, the November 27, 1985 issue of "The Wall Street Journal" reported that Japan had followed American banks in resuming loans to the Soviet Union. Therefore, the U.S. does carry a leadership role in world commerce and needs to be setting the proper example for other free world countries.

Q.2. U.S. BANKERS ALSO CLAIM, ENACTMENT OF S. 812 WOULD RESULT IN A LOSS OF BUSINESS TO OUR BANKS WITHOUT ACHIEVING ANY INCREASE IN OUR NATIONAL SECURITY OR OTHER POLITICAL OBJECTIVES. WHAT DO YOU THINK OF THESE ARGUMENTS?

SENATOR MOYNIHAN IN TESTIFYING BEFORE THIS COMMITTEE ON THE POLISH DEBT QUESTION IN 1982 SAID THE AIM OF THE POLICY OF DETENTE WAS TO LURE THE EASTERN EUROPEANS, AND THE SOVIETS THEMSELVES INTO AN EVER-LARGER NETWORK OF INTER-LOCKING TRADE RELATIONS WHICH THEY WOULD BE RELUCTANT TO DISRUPT AND THUS IT WOULD INDUCE THEM TO BEHAVE IN WAYS MORE ACCEPTABLE TO THE DEMOCRACIES. HE CONCLUDED BY ASKING, "WHAT HAS HAPPENED? AFGHANISTAN TEACHES US ONE LESSON. THE SUPPRESSION OF SOLIDARITY ANOTHER. WE HAVE FOUND OURSELVES HOSTAGE TO THE VERY TRADE RELATIONS WE ESTABLISHED IN ORDER TO CAPTURE THE COMMUNIST STATES." DO YOU AGREE WITH SENATOR MOYNIHAN'S VIEWS ON DETENTE? DO YOU LIKEWISE THINK S. 812 MIGHT BE A USEFUL TOOL FOR THE PRESIDENT TO HAVE IN DESIGNING OUR OVERALL RELATIONSHIP WITH THE SOVIET UNION?

A.2. Historically speaking, the opposite result has been found to be true. Business is being lost as a result of not having S. 812, compounded with the fact that our national security is on the line and our country's worthwhile political objectives are weakened when such loans to communist countries are given. For example, western bankers have already lost approximately of $80 billion in capital to the Soviet Union and its allies. This $80 billion does not include the interest that might have been earned, had western banks invested elsewhere. American businesses would welcome the favorable loan terms given to communist countries: no money down, a four to seven year grace period, an interest rate ceiling of 9 percent, and history of rescheduling the loan if there is any question of possible default. Moreover, American business loans would be more controllable because the loans are almost always secured by collateral. Soviet Bloc countries have received unsecured loans and have threatened to default on their loans.

This country's needless revenue loss from business loans is disheartening, but the problem of even greater concern lies with how these loans have been used over the years. For example, in 1917 when Chase National Bank, Equitable Trust Company, Guaranty Trust Company, And National City Bank gave substantial loans to communists during the Russian Revolution.

In December of 1982, Bank of America put together a $25 million loan to Marxist Nicaragua. Chase Manhattan Bank financed 45% of the Soviet Kama River Truck Plant at 6 percent, no money down and a four year grace period. Many Kama River trucks are now rolling into Afghanistan.

Even the Export/Import Bank of the United States has even gotten involved with loans totaling over $200 million for oil development in Angola. Oil revenues are now being used to finance Soviet and Cuban troops and advisors in that Marxist country. The more capital that is made available to Soviet Bloc countries, the more free they are in pursuing their political objectives. By limiting western credits, we are more able to better bridle communist ambition. Soviet Bloc countries will be forced to divert their priorities to domestic fronts.

The Soviet Bloc has fooled western governments and credit sources many times. It has been said, "Fool me once, shame on you. Fool me twice, shame on me." Unfortunately, it fits. By giving the President discretionary authority, we can formulate better policy in regard to these loans.

The CHAIRMAN. Next we will hear from William McDonough, executive vice president and chief financial officer, First Chicago Corp; and George Clark, executive vice president of Citibank.

Gentlemen, first of all, while you're sitting down, let me compliment you for your courage. You're among the bravest witnesses I've had before the committee in some time, particularly when you have been able to listen to the previous testimony and listen to a majority of the members of this committee. I'm sure you did not expect otherwise, so your bravery to come in and take the other side of this issue is appreciated.

Mr. McDonough.

STATEMENT OF WILLIAM J. McDONOUGH, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, FIRST CHICAGO CORP.

Mr. McDONOUGH. Thank you, Mr. Chairman.

Mr. Chairman, and members of the committee, my name is William J. McDonough. I am executive vice president and chief financial officer of First Chicago Corp., a bank holding company whose principal subsidiary is the First National Bank of Chicago.

The CHAIRMAN. Mr. McDonough, I hate to interrupt you, but that is halfway through a vote and we're going to have to recess long enough for me to play O.J. Simpson over to the Capitol and vote and I will return as rapidly as I can. I apologize for the interruption but I can't control the lights and bells when Bob Dole pushes the button.

[Recess.]

Senator PROXMIRE. The committee will come to order. The chairman has asked me to continue the hearing in his absence. He'll be in shortly.

Mr. McDonough, go right ahead, sir.

MULTINATION LOAN TO U.S.S.R.

Mr. McDONOUGH. Senator Proxmire, I was mentioning in my testimony that First Chicago and a group of foreign international banks—Finnish, French, Japanese, Jordanian, and West German—underwrote a $200 million loan to the Bank for Foreign Trade of the U.S.S.R.

It is an 8-year term loan priced at one-quarter of 1 percent over the London InterBank offer rate. That, as you know, is the rate at which banks trade money among themselves, terms and conditions consistent with market forces prevailing at that time.

I should note that this is a purely free market. It is one in which the borrower obviously seeks to negotiate the best at which it can possibly borrow. It is the one at which the banks would prefer that the rate be higher. And the two come together in a free interchange and see the rate at which the market will clear—the rate at which the banks were willing to put up $200 million—and the U.S.S.R.'s Foreign Trade Bank was willing to borrow it was that rate reached in the methodology of the free market.

[The complete prepared statement follows:]

Testimony of

William J. McDonough

Executive Vice President and Chief Financial Officer

First Chicago Corporation

Mr. Chairman, and Members of the Committee, my name is William J. McDonough. I am Executive Vice President and Chief Financial Officer of First Chicago Corporation, a bank holding company whose principal subsidiary is the First National Bank of Chicago.

The First National Bank of Chicago is an international financial institution, and our headquarters city is both a Midwestern and an international financial center. For this reason, I am pleased to have the opportunity to be here today to testify regarding Senate Bill 812, the Financial Export Control Act.

Mr. Chairman, the largest industry in the Midwest is agriculture. It is larger than any single manufacturing industry. And in a recent year, nearly one out of every two farm-income dollars in the Midwest -- 46 percent of agricultural income, to be specific -- was generated by export sales of such crops as wheat, corn, and soybeans.

That figure of 46 percent can be put in an appropriate perspective by noting that the comparable statistic for farmers nationwide was 27 percent. This indicates clearly that Midwestern agriculture -- one of the two pillars of the region's economy -- is even more oriented toward international trade than is American agriculture, in general.

The second pillar of the Midwestern economy is manufacturing. And here, too, exports are important. Specifically, trade accounts for no less than 20 percent of Midwestern manufacturing production. And export orientation is particularly strong in the region's machine tools and industrial machinery industries, which provide jobs for hundreds of thousands of Midwesterners.

At the national level, agricultural products and machinery account for nearly half of all American exports. And in both of these categories, the Midwest is dominant.

International trade is of particular significance to our region of the country. And First Chicago, as an international financial institution, is committed to helping to meet the financial needs of the Midwest.

The international exchange of goods takes place because it creates economic benefits for both trading partners. That exchange also gives rise to the need for international financial transactions. In fact, as a practical matter, international trade would be impossible without international finance.

In light of the fact that the Midwestern economy is so strongly linked to international trade, perhaps it is not surprising that Chicago has evolved into a major international financial center. As such, it is the "home base," if you will, of several international banks, including First Chicago. In addition, many other domestic and foreign international banks have offices in the city.

It can accurately be said that Midwesterners in every walk of life have a vital interest in issues related to our Nation's trade policy.

For the most part, the trade policy of the United States is based on a recognition of the economic benefits of free trade. In the case of trade with non-market -- specifically, communist -- countries, our Nation's policy has, quite appropriately, reflected vitally important foreign policy and national security considerations. They are, of course, embodied in the Export Administration Act of 1979.

Senate Bill 812 would amend the Export Administration Act in such a way as to authorize controls on the transfer of capital from the United States. The purpose of these controls would be to prevent the Soviet Union and its allies from obtaining sensitive goods and technology, thereby damaging the security interests of the United States and its allies.

Surely, no American would object to any legislation that would prevent the security of our Nation and our allies from being diminished.

In my opinion, however, it is not clear that Senate Bill 812 would, in fact, make a meaningful contribution to preventing the security of our Nation and our allies from being impaired. One reason why I say this is that the controls specified in this Bill would not prevent the Soviet Union and its allies from raising funds through non-American institutions.

This is borne out by the fact that fully 86 of the 100 largest banks in the world are foreign institutions.*

The First National Bank of Chicago recently participated in a transaction with the Bank for Foreign Trade of the U.S.S.R., Vneshtorgbank, that reflects the sizeable presence of foreign banks in the international financial marketplace.

During July and August, First Chicago and seven foreign international banks -- Finnish, French, Japanese, Jordanian, and West German -- underwrote a $200 million loan to the Bank for Foreign Trade.

[*"The Top 500 Banks in the World: U.S. and Overseas Banks Ranked by Size of Deposits," American Banker, July 29, 1985, p. 67.]

It is an 8-year term loan priced at one quarter of one percent over LIBOR (the London InterBank Offer Rate) -- terms and conditions consistent with market forces prevailing at that time.

This syndication, which ultimately involved 27 foreign international banks plus First Chicago, was preceded by six other syndications earlier in this year. They were led by major English, French, Middle Eastern, Swiss, and West German banks.

And we are of the understanding that two additional syndications may be led by major European banks before year's end.

It can be noted that, for what we believe to be the first time ever, the Bank for Foreign Trade of the U.S.S.R. stated in the loan agreement that the purpose of the borrowing was to fund normal trade flows. At the final signing ceremony, a senior official of the Foreign Trade Bank stated in his formal remarks that, in keeping with that bank's usual practice, the proceeds of the loan would be used to fund imports from the home countries of the participating banks.

The Soviet Union is one of the few countries in the world with which the United States enjoys a favorable balance of trade. And, inasmuch as the U.S.S.R. is a significant importer of American grain, we at First Chicago are hopeful that this transaction will stimulate exports from the Midwest.

I might also note that First Chicago sold the predominant part of its underwriting portion of the loan to foreign banks in Japan and Europe. Our participation at the time of the final signing of the loan on August 27 in London was less than 7 percent of the total amount of the transaction. That will be further reduced to approximately 5 percent.

And, as is the case with almost all of our international lending, our participation in the Foreign Trade Bank loan will have utilized deposits and other funds raised in international markets. Domestic American funds played no role in this transaction.

As a matter of fact, the principal attraction of this transaction for First Chicago was the fees we earned for our activities as an investment banker -- who serves merely as an intermediary between a borrower and lenders.

Naturally, whether it is foreign exchange transactions with the Soviet Union, participation in a credit facility with East Germany, or lending to the People's Republic of China, First Chicago's financial dealings with non-market economies are both apolitical and consistent with the policies, laws, and regulations of our Nation.

There is another reason why I believe that Senate Bill 812 would not contribute substantially to preventing the security of the United States and its allies from being damaged.

This second reason has to do with the fact that it would appear that Senate Bill 812 could, even unintentionally, stand in the way of an expansion of mutually beneficial trade with the Soviet Union.

As you know, in May of this year, the Joint U.S. - U.S.S.R. Commercial Commission met in order to discuss trade matters. It was the first meeting of the Joint Commercial Commission since 1978.

An Agreed Report was issued at the close of the session. And this report, signed by Secretary of Commerce Baldrige, stated that the United States believes that both sides should take concrete steps to expand trade.

In fact, in a message to the American business community* regarding the Joint Commercial Commission meeting, Secretary Baldrige stated that "The President is seeking to build a more constructive working relationship with the Soviet Union, and he favors an expansion of peaceful trade with the U.S.S.R. as part of this effort."

And this brings me back to Senate Bill 812.

Our country's export control regulations already contain provisions that are designed to prevent the Soviet Union and its allies from obtaining sensitive goods and technology. Therefore, expanded trade, which would, of course, have to be in accordance with those export control regulations, would not result in increased availability of those goods and technology to the U.S.S.R.

Therefore, it is possible that Senate Bill 812 would not, on a practical level, strengthen the Export Administration Act of 1979. Nevertheless, it might be the case that the enactment of this Bill would prove to be inconsistent with the efforts of the President to enhance the security of our Nation by expanding peaceful trade with the Soviet Union.

In summary, Mr. Chairman and Members of the Committee, we at First Chicago Corporation agree with the intent of Senate Bill 812 -- namely, to avoid the damage to the security of our Nation and our allies that might result from the acquisition of sensitive goods and technology by the Soviet Union and its allies.

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[*"A Message To The American Business Community," Business America, Vol. 8, No. 12, June 10, 1985. Business America is a biweekly magazine of international trade published by the U.S. Department of Commerce.]

We believe, however, that Senate Bill 812 would make no meaningful contribution to preventing the Soviet Union and its allies from obtaining those goods and technology. And, at the same time, the enactment of this Bill might undermine the efforts of the President to enhance our security by expanding peaceful trade with the U.S.S.R. Such a development would be inadvertently detrimental to the Midwest -- a region whose economy is strongly linked to international trade.

PRESIDENT IS SEEKING A MORE CONSTRUCTIVE WORKING RELATIONSHIP

Senator **Proxmire**. Mr. McDonough, you say in your last few remarks that Secretary Baldrige in a message to the American business community said the President is seeking to build a more constructive working relationship with the Soviet Union and he favors an expansion of peaceful trade with the Soviet Union as part of this effort.

If the Congress enacts S. 812 and gives the President discretionary authority to regulate bank loans to the Soviet bloc, why is that inconsistent with expanding peaceful trade with the Soviets? How could that—as you conclude it will—undermine the efforts of the President to enhance our security by expanding peaceful trade with the Soviet Union?

He's given the discretionary authority. It's up to him.

Mr. **McDonough**. Senator, I think that there's no question that one would find it difficult to argue that the enactment of this bill would bring about the end of trade between the two countries and therefore it is easy to exaggerate one's position on this subject.

However, I believe that it comes down to the signal of whether we use trade as a political tool which on occasion can be a good idea, or whether as a general matter we try to have trade be trade and protect our national security interests in a more direct way.

I think that the signal that was given by the trade embargo a number of years ago during the Carter administration encourages people who can buy commodities such as grains to think of the Canadians, the Argentines, the Brazilians, et cetera, as being more reliable sources.

Therefore, although I think that the discretionary aspect of S. 812, which you correctly point out, does give the President the discretion and therefore he can either use it or not, the signal that it gives of using trade as a political instrument could have an adverse effect on trade. There is no way I can assure you whether it would or would not.

Senator **Proxmire**. But that's a matter of judgment on the part of the President of the United States.

Mr. **McDonough**. It is indeed.

Senator **Proxmire**. It seems to me in view of the fact that this is our prime adversary in the world and it's costing us about $300 billion in defense expenditures just because the Soviet Union does pose this colossal threat, it seems to me under these circumstances we should give the President discretion to make up his mind in this regard.

Let me ask you one other question and then I'll yield to the chairman. You and Mr. Clark both might want to answer.

In December 1984, the Joint Economic Committee issued a "Report on East-West Technology Transfers" with an appendix that said the following:

> The capital resources of the U.S. economy are limited. When the United States Government or United States private lenders extend credit to the Soviet Union or Eastern Europe to finance trade they divert capital away from some alternative domestic or international use.

The chairman made that point very well in his opening statement you probably heard.

Now is that a fair statement, and if so, doesn't that lend credence to charges that when U.S. banks finance trade with the Eastern bloc there are fewer resources to deal with the financial needs of American home buyers and other borrowers? Doesn't it also mean that our home borrowers and other borrowers have to pay more for available credit than would otherwise be the case?

Mr. McDonough. Let me answer the first part of the question first and that is, is it a drain of some sort of capital from the U.S. economy which could be used for the U.S. economy as a whole? I think the answer to that is no, and that's why I think the linkage of finance and trade and the fact that we try to make sure that the funds are in fact used to purchase things in the United States is very important.

The ability, as I stated in my testimony with its Midwestern orientation, the ability of Midwestern farmers to sell grain to the Soviet Union and its allies, the ability therefore of tractor manufacturers to sell tractors to the farmers, is a net benefit to the American economy. I think that's clear.

Does the fact that those moneys are going to that use of capital as opposed to into the mortgage market make mortgage interest rates higher, I think as a general matter the answer is no, but this, as you well know with your training in economics, is something that economists have spent a lifetime arguing, of whether there is a likelihood that if you're using money to purchase—if you're using savings to purchase the bonds of United States Steel Corp., that it is depriving the people who would like to borrow money for a mortgage of either funds or raising the interest rate.

Senator Proxmire. Mr. Clark, would you like to respond?

Mr. Clark. Yes, I would.

Senator Proxmire. It's the view of the Joint Economic Committee and I've been a member of that committee for 25 years. The Joint Economic Committee says that our capital is limited and therefore if we provide capital resources to the Soviet Union they're not available to our own economy.

U.S. BANKS HOLD VERY LITTLE EASTERN BLOC LOANS

Mr. Clark. Senator Proxmire, just to put the subject just a little bit in perspective, U.S. banks hold so little Eastern bloc money. We're talking about a subject which the listener would think the outstandings are very large, but all U.S. banks have only about $2.3 billion of the actual worldwide bank loans outstanding to all the Comecon countries put together, some $47.5 billion. Now we're talking about a U.S. domestic banking system here of tens of billions of dollars. Citibank alone has a balance sheet of $150 billion, one institution. So the $2.3 billion that we the U.S. banks as a group, have outstanding to the Comecon countries is well less than 1 percent of our total balance sheets collectively, and it's probably about one-tenth of 1 percent.

So the impact that it could have on the lending activities of the rest of the institutions is really almost negligible.

Senator Proxmire. That sounds like an observation of Senator Dirksen, "A billion here and a billion there pretty soon adds up to real money."

Mr. **Clark**. Well, the fact is we are talking about an enormous banking system.

Senator **Proxmire**. I realize that. And it's also the moral and the symbol, the fact that we are making resources available. As the chairman pointed out, the rural economy and others are desperately in need of funds.

Mr. **Clark**. Yes, sir. But the banking system is capable of meeting all of those needs and the fact that such a tiny amount is diverted—the other thing to be said, of course, is the source of the funds is actually offshore. These are 100 percent Eurodollar transactions which are out of the Eurodollar market and they're not out of the U.S. market anyhow.

One other point, if I could, Senator Proxmire, a lot of the discussion here has been in terms of our lending to the Soviets. By and large, that's not what these transactions have been. By and large, these have been syndications where the banks have sold off their exposures to other financial institutions—almost entirely non-U.S. financial institutions. For example, 85 percent of the outstandings in our recent East German transaction, are with non-U.S. financial institutions.

Senator **Proxmire**. I keep coming back to that statement that haunts me that Lenin is alleged to have said many years ago that when the Communists get ready to hang the capitalists, the capitalists will sell them the rope.

The **Chairman**. The next step is that we would loan them the money to buy the rope to hang us.

Senator **Proxmire**. Very good.

Senator **Hecht**. Cash or terms? [Laughter.]

The **Chairman**. Mr. Clark, you haven't had the opportunity for your testimony yet. If you'd like to, proceed.

STATEMENT OF GEORGE J. CLARK, EXECUTIVE VICE PRESIDENT, CITIBANK, N.A.

Mr. **Clark**. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I'm George Clark, executive vice president of Citibank, and I am prepared to discuss the matters raised in your letter of September 10 concerning Senate bill 812, the proposed Financial Export Control Act.

The chairman's letter asks for our views on both the specific legislative proposal and on the terms and conditions of recent loans to the Soviet bloc.

Permit me to respond to the second request first, the conditions of recent loans to the Soviet bloc, as background for considering the legislation itself.

BELT TIGHTENING OF EASTERN BLOC NATIONS

The Polish and Romanian debt-servicing crisis of 1981 had a deep effect upon the entire Eastern European region. It was clear, just as it was later recognized in Latin America, that a severe adjustment on the part of each national economy was necessary, if continued access to external credit was to be preserved. The belt tightening was severe, reflecting both the conscious planning of adjustment policies and the reluctance of Western commercial banks to continue to lend into the area. With the exceptions of Poland and Romania, the countries of the region were able to continue to service their external debt punctually without having to resort to reschedulings—a noteworthy achievement, since we have seen so many reschedulings in other parts of the world.

As the global banking industry observed this performance record, a resumption of lending began to occur.

Senator Garn, you've been asking about what changes there are. I think part of the answer lies here. We did have this performance record behind us.

However, some of the characteristics of today's market differ markedly from that of the 1970's.

There is a reinforced awareness on the part of the U.S. banks of the vulnerability of the region to balance-of-payments problems and potential debt-servicing crises, as well as unpredictable political developments affecting East-West relationships in general. These perceptions have had several impacts on the financial markets.

Some banks, especially smaller institutions, have ceased to lend at all to the region, as, indeed, some have entirely withdrawn from the international marketplace. The banks which have remained in the market are much more reluctant to engage in general purpose, medium-term balance-of-payments loans than previously.

Some characteristics of the market, however, remain the same, and they are important to recognize. It has long been a market in which the U.S. banks have been comparatively minor players. The Bank for International Settlements and the Federal Reserve figures reflect that, of the bank debt of the Comecon countries, only 5 percent is held by U.S. banks; of total Comecon debt, estimated by the United Nations, of $86 billion at the end of 1984, the U.S. banks' share was only 2.7 percent.

Even the most recent transactions, heralded by the media as reflecting a renewed appetite on the part of U.S. banks for Eastern European borrowers, was widely subscribed by non-U.S. institutions. For example, together with the Bank of America, the Bank of Tokyo, and Manufacturers Hanover Trust, Citicorp lead managed a syndication for East Germany in March 1985, totaling $500 million, but of this amount, the U.S. banks' share totaled less than 15 percent. Furthermore, much of the exposure initially underwritten by U.S. banks is sold onward into a marketplace of willing buyers, largely foreign banks, so that the final share of this transaction actually kept on the U.S. books is even lower than the 15 percent I mentioned earlier.

I should point out that while the margin of ⅞ percent over the London Interbank Offered Rate [LIBOR] represented an improvement for the borrower for the marketplace terms 6 months previously, that margin was actually attractive to the creditors, because it exceeded the normal return available on loans made to sovereign borrowers—especially with the addition of a U.S. prime rate pricing option available to the creditors, which further increased their return on the transaction.

Syndicated loans represent only a small portion of financial activity. Banks are also engaged in bank-to-bank transactions, à forfait financings and programs of various governments to promote exports. In these markets, as well, non-U.S. banks have shown such appetite for extending credit that the terms Eastern European borrowers pay have dramatically improved.

Again, U.S. banks have played a relatively minor role in this development.

Why is the market taking this shape, and how are bank policies evolving?

U.S. banks, under increasing for capital ratio increases, have had to look especially closely at finely price transactions, on which the return may not meet institutional targets. (And this applies equally to loans to other geographic areas.)

ACTIVE MARKET ELSEWHERE FOR EASTERN EUROPEAN EXPOSURE

As I mentioned earlier, there is an active market elsewhere for Eastern European exposure, especially for those countries who adjusted their economies and have serviced their debts punctually throughout this period.

Some U.S. banks have therefore considered it prudent to pursue more of a classic merchant bank business, namely, to earn the fees available in the marketplace for organizing transactions, but to spread the risk by selling it off in the active secondary markets.

This is simply the most rational approach to a marketplace in which our Japanese, Middle Eastern, and European competitors have driven the pricing ever lower on Eastern European transactions, too low to be significantly interesting to the U.S. banks.

In a sense, these factors have always been at work and our exposure has been held down by a combination of poor returns and special perceptions of risk.

At Citicorp, as a proportion of our overseas cross-border exposure, this entire region has never amounted to more than a small fraction of our total portfolio, and in the past 2 years, it has accounted for under four-tenths of 1 percent.

Let me now turn briefly to our initial question, namely, my views on the proposed Financial Export Credit Act.

While I defer to our political officials on the setting of our foreign policy goals, perhaps I can be most helpful by raising what is probably the central question concerning the approach taken by Senate bill 812 as a means toward attaining those goals.

Against the backdrop, as I have described it, of the evolution of the global capital markets over these recent decades, in which U.S. banks play less and less of a role as a portion of the whole, I must ask the question: How can legislation, which confers authority to control only U.S. banks' activities, be really effective?

Is this approach not doomed to the same real world conditions which inhibit the effectiveness of our strategic export control programs, as the chairman has pointed out, namely, that we cannot control total flows of either goods or of capital by unilateral U.S. action in today's world? Indeed, could we not expect bilateral and multilateral negotiations to be more successful on the limitations of exports of strategic materials themselves, than on the financial flows to the country concerned?

In short, Mr. Chairman, as you can tell from these brief remarks, I question whether the proposed legislation can achieve the intended effect in today's global financial markets. In my judgment, restraints on the U.S. banks alone, in view of their relatively small share of the marketplace, will not significantly affect either the volume of hard currency lending to the Soviets or the pricing of credits available to them.

I'd be pleased to answer any questions that may follow from this testimony.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

Testimony of
George J. Clark,
Executive Vice President,
Citibank, N.A.

Mr. Chairman and members of the Committee:

I am George J. Clark, Executive Vice President of Citibank, N.A. I am prepared to discuss the matters raised in the Chairman's letter of September 10, concerning S. 812, the proposed Financial Export Control Act.

The Chairman's letter asks for our views on both the specific legislative proposal and on the terms and conditions of recent loans to the Soviet Bloc.

Permit me to respond to the second request first, as background for considering the legislation.

The Polish and Romanian debt-servicing crisis of 1981 had a deep effect upon the entire East European region. It was clear, just as it was later recognized in Latin America, that a severe adjustment on the part of each national economy was necessary if continued access to external credit was to be preserved. The belt-tightening was severe, reflecting both the conscious planning of adjustment policies and the reluctance of Western commercial banks to continue to lend into the area. With the exceptions of Poland and Romania, the countries of the region were able to continue to service their external debt punctually without having to resort to reschedulings.

As the global banking industry observed this performance record, a resumption of lending began to occur. However, some of the characteristics of today's market differ markedly from that of the 1970's.

There is a reinforced awareness, on the part of U.S. banks, of the vulnerability of the region to balance-of-payments problems and potential debt-servicing crises, as well as unpredictable political developments affecting East-West relationships in general. These perceptions have had several impacts on the financial markets. Some banks, especially smaller institutions, have ceased to lend at all to the region (as, indeed, some have entirely withdrawn from the international marketplace). Those banks which have remained in the market are much more reluctant to engage in general-purpose medium term balance-of-payments loans than previously.

Some characteristics of the market, however, remain the same, and are important to recognize:

- It has long been a market in which the U.S. banks have been comparatively minor players. The BIS and Federal Reserve figures reflect that, of the bank debt of the COMECON countries, only 5% is held by U.S. banks; of total COMECON debt, estimated by the United Nations as $86 billion at end-1984, the U.S. banks' share is only 2.7%.

- Even the most recent transactions, heralded by the media as reflecting a renewed appetite on the part of U.S. banks for East European borrowers, were largely subscribed by non-U.S. institutions. For example, together with Bank of America, Bank of Tokyo, and Manufacturers Hanover Trust Company, Citicorp lead-managed a syndication for East Germany in March, 1985, totaling $ 500MM, but of this amount, the U.S. banks' share totaled less than 15%. Furthermore, much of the exposure initially underwritten by U.S. banks is sold onward into a marketplace of willing buyers, largely foreign banks, so that the final share of this transaction actually kept on the books of U.S. banks is even lower. (I should point out that, while the margin of 7/8% over LIBOR represented an improvement for the borrower over marketplace terms six months previously, that margin was actually extremely attractive to the creditors, exceeding that normally available to sovereign borrowers -- especially with the addition of a U.S. prime rate pricing option available to the creditors, which further increased their return on the transaction.)

- Syndicated loans represent only a small portion of financial activity. Banks are also engaged in bank-to-bank transactions, a forfeit financings, and programs of various governments to promote exports. In these markets as well, non-U.S. banks have shown such appetite for extending credit that the terms East European borrowers pay have dramatically improved. Again, U.S. banks play a relatively minor role.

Why is the market taking this shape, and how are bank policies evolving? U.S. banks, under increasing pressures for capital ratio increases, have had to look especially closely at finely-priced transactions on which the return may not meet institutional targets. (And this applies equally to loans to other geographical areas.) As I mentioned earlier, there is an active market elsewhere for East European exposure, especially for those countries who adjusted their economies and have serviced their debts punctually throughout this difficult period. Some U.S. banks have therefore considered it prudent to pursue more of a classic merchant-banking business: namely, to earn the fees available in the market place for organizing transactions, but to spread the risk by selling it off in the active secondary markets. This is simply the most rational approach to a marketplace in which our Japanese, Middle Eastern and European competitors have driven the pricing even lower on Eastern European transactions -- too low to be significantly interesting to the U.S. banks.

In a sense, these factors have always been at work, and our exposure has been held down by a combination of poor returns and special perceptions of risk. At Citicorp, as a proportion of our overseas cross-border exposure, this entire region has never accounted for more than a very small fraction of our portfolio, and in the past two years it has accounted for under four tenths of one percent.

Let me now turn briefly to your initial question: namely, my views on the proposed Financial Export Credit Act. While I defer to our political officials on the setting of our foreign policy goals, perhaps I can be most helpful by raising what is probably the central question concerning the approach taken by S. 812 as a means toward attaining those goals.

Against the backdrop, as I have described it, of the evolution of the global capital markets over these recent decades, in which U.S. banks play less and less of a role as a portion of the whole, how can legislation which confers authority to control only U.S. banks' activity be effective? Is this approach not doomed by the same real-world conditions which inhibit the effectiveness of our strategic export controls programs, as the Chairman has pointed out: namely, that we cannot control total flows of either goods or of capital by unilateral U.S. action in today's world. Indeed, could we not expect bilateral and multilateral negotiations to be more successful on the limitation of exports of strategic materials themselves than on financial flows to the countries concerned?

In short, Mr. Chairman, as you can tell from these brief remarks, I question whether the proposed legislation can achieve the intended effect in today's global financial markets. In my judgment, restraints on the U.S. banks alone, in view of their relatively small share of the marketplace, will not significantly affect either the volume of hard currency available to the USSR or the pricing of credits available to them.

I shall be pleased to try to answer any questions the Chairman or your fellow committee members may have.

Thank you.

The **Chairman**. Thank you, Mr. Clark.

Mr. Clark, I certainly can't dispute your figures and don't intend to try on the size of the exposure. I don't think that really is the point. I can agree that it's very small.

POOR PERCEPTION OF THE SITUATION

We are attempting to deal here with some principles, and if I've learned anything on this committee, it's perceptions. The perception of the difficulty it causes is much larger than the reality. I don't think there's any doubt about that. I think the impact is larger than the percentages that you present to the committee, but I have a hard time accepting this argument that I have heard on so many different things, whether it's sanctions on grain, or whatever, that we might as well do it, because everybody else is doing it, and they'll fill in the gap.

That's like me saying, "Well, I'll be honest 95 percent of the time, but 5 percent of the time I'm going to lie to my colleagues for something," or "There's no point in enforcing laws in this country like speeding, because we can't catch all the speeders." "Drunk drivers kill 25,000 people a year. We're not going to try to get them off the roads, because we can't get all of them."

So I really can't accept it as a reason or a good argument that it's small, and therefore, we might as well go ahead and do it. Everybody else does it.

I'll get back—you heard what I said, we ought to put a great deal more pressure on our allies.

But explain to me more about the terms. You touched on it there, but even if we assume that this is not good legislation, we should not give the President this authority, and we should not interfere with the commercial sector.

I'll go back to my example of being told that we could not commercially, feasibly—United States banks could not finance the United States pipeline from Canada to bring natural gas down.

You know what the interest rates were at the time, and this was not the United States, this was primarily German and French banks on the Yamal pipeline. And I understand that. But I cannot explain the favorable terms that are given. I can't even on the economies of scale. I can't go home and explain to a Utahan that, well, you're only asking for an $80,000 loan on a house, and it costs as much to process that as a $10 billion loan, and all that.

You still can't justify and explain why an avowed enemy of the U.S. economy is enhanced by treating them far, far better than the marketplace.

Can you explain it to me?

Mr. **Clark**. Yes, sir, I think I can. You mentioned earlier on, why don't the Soviets pay market terms? These transactions are priced at market. The market that we are talking about is the Eurodollar market, and that's a market that is out there, and the rate is quoted hourly, and Soviets use the Eurodollar moneys, and we charge them fees beyond the level of the markets. And those rates go up and down, and sometimes they may be higher than U.S. rates. Sometimes they may be lower. Right now they're lower. Very often they're lower.

As far as, you know, the American market, and I, in my own mortgage loan, and so on, that's a very different market. I am not borrowing for my mortgage in the Eurodollar market, and I'm not borrowing in lumps of $100 billion or $100 million or $500 million, I'm borrowing maybe $50,000, and the bank has got a whole different series of costs associated with that. Consumer credit is basically a much more expensive type of credit. These Eurodollar transactions you can do in enormously large chunks with really no additional overhead. We all have our organizations in place, so the marginal cost is pretty much the cost of the funds in the Eurodollar market. But if we engage in a new lending program for agriculture, we have to organize for that; it's a very people-intensive type activity, and the costs associated with it are very high.

We probably make more money, in terms of actual profit, on these very large Eurodollar transactions, even though they're priced very thin, because we can handle them in such large bulk, and they have so little overhead associated with them.

The **Chairman**. Well, I have a hard time believing—I can accept your answer in some cases, but I have a hard time believing, when the prime was 21½ percent in the United States, that we had that kind of a spread, where it was profitable and more profit down at 7 and 9 percent than looking at what the general rate was in this country.

I can't accept that there was that big a spread.

Mr. **Clark**. At that particular time, Senator Garn, the Eurodollar rates were also in the 19-, 20-, 21-percent rate. They go up, and they come down, and the U.S. rates go up and down. There are some linkages, but you do have periods——

The **Chairman**. Yes, but on the Yamal pipeline, that even makes my point more strongly, and they were undercutting the Eurodollar rate by 10 percent to make loans to the Soviet Union.

Mr. **Clark**. I don't recall on what basis the pipeline was financed, but you know, if there was any undercutting, it was through some kind of government intervention.

As far as the private institutions are concerned, we do all of these transactions at LIBOR plus our spread and our fees.

The **Chairman**. Well, I don't remember the exact figure. It seems to stick in my mind about 7 to 9.7 percent, in that area.

Mr. **Clark**. Were there official credits involved in that? That may be the answer.

The **Chairman**. There was obviously government——

Mr. **Clark**. As soon as you get the government in, wild things happen. [Laughter.]

The **Chairman**. In intervention, but nevertheless, that was the factual situation at the time. But if it's such a small amount of your business, then why the eagerness to get involved in it?

TRANSACTION ENDED UP AT $500 MILLION

Mr. **Clark**. Eagerness, I don't know. We are in the business of making financial markets, and in the case of the East German transaction, which was a very interesting one, the original mandate was for $100 million. And when we went out to the markets, we found, that the East German credit standing was so high that there was appetite there to do much more than $100 million, and the transaction ended up at $500 million. And as I say, that was not U.S. banks that were showing that appetite. Those were the capital markets of the world.

The CHAIRMAN. Mr. McDonough, in your written statement, you say that your dealings with nonmarket economies are apolitical. It is interesting that you say the policy applies to nonmarket economies.

Does that mean that your dealings with market economies are apolitical—or not apolitical, they're political?

Mr. MCDONOUGH. No, Mr. Chairman. I think that most people would assume, and it is the case, that our relations with market economies and certainly with democracies are apolitical. I think the question comes as to whether private sector banks, in dealing with our adversaries in Eastern Europe should be political.

As citizens, we have every right and every opportunity to seek to have the Government of the United States, both the administration and the Congress do what is necessary to defend the interests of the United States. As must be readily apparent in my remarks, I am a great believer in a strong defense position. I'm a great believer in a very strong-minded foreign policy.

I think that the banks should and bankers should carry out their responsibilities as citizens in that regard and follow the laws of the land and not seek to become sort of amateur secretaries of state in their business transactions with other countries, an area in which there is very little expertise.

The CHAIRMAN. Would you describe your lending policies toward South Africa as apolitical?

Mr. MCDONOUGH. Well, in our particular case, we can't comment very actively on South Africa. It's not a country which has a very active trade relationship with our part of the country, and that's where we tend to be involved in our overseas activities.

So by historic accident, to some degree, pushed by a very activist community in Chicago with very strong views on South Africa, we have no loan exposure in that country, but that's been true for quite a number of years.

DOUBLE STANDARDS ON SANCTIONS

The CHAIRMAN. You see we have great double standards in this body. I don't want to be misunderstood. I don't agree with apartheid. I don't understand it. I don't understand a Government policy that treats any people so differently as they do. But on the other hand, what we are attempting to do there violates all the testimony I hear on any other country. I heard it on the floor of the Senate. We apply it to South Africa. But we're not supposed to apply it to the Soviet Union or the Eastern bloc nations. It doesn't matter what they do to Solidarity. It doesn't matter how many thousands of people they kill, how many they imprison.

It disturbs me, too, that we have double standards, because I'll hear all the arguments about why we should make loans to the Soviet Union, whether it's size, whether some other country will do it or not. Somehow we pick on South Africa as different.

I'd be for the sanctions we're applying to South Africa, if we would apply them to all countries who are violating human rights, without regard to individual country politics. I think it rather easy to make a clear case from outside sources, Amnesty International or any others, about the policies of the Soviet Union, the violations of the Helsinki accords, but we're not even supposed to call them an evil empire.

I wish I could understand how some of my colleagues and critics out there can play both sides of it. I'm not capable of playing both sides of an issue that is obviously so blatant and so political and generated by domestic political politics in this country. And I say that, fine, I'd vote for the sanctions bill on South Africa, if it applied to Poland, Romania, Bulgaria, the Soviet Union, other countries that are in violation, and Soviet—formerly Rhodesia. See what has happened in that country and 30,000 or 40,000 people killed in the opposition.

Mr. Clark, your bank operates branches and offices all over the world. Loans can be made from these—any of these branches, I assume. Trying to understand the extent of United State exposure in Soviet Bloc countries, aggregate figures are available for long-term and medium-term loans do those aggregates also adequately represent short-term loan exposures, such as trade credits and bankers acceptances?

Mr. CLARK. I don't know what data you have there, Senator Garn, but we do report to the U.S. Government our total exposure in all of these countries, including our short-term. I notice the Polish Ambassador said that short term was not in there. Our short term is in there. And I don't know what your data has.

DEPOSITS IN SOVIET-OWNED BANKS

The CHAIRMAN. Well, there's another form of exposure as well, and I'm referring to deposits of Western banks in Soviet-owned banks in the West, which are located in London, Paris, Vienna, Zurich and elsewhere.

Examples are the Moscow Norodny Bank in London, the Singapore Eurobank, and so on, various countries.

What is the extent of Citibank's current worldwide exposure in the form of deposits in Soviet-owned banks?

Mr. CLARK. Well, it happens to be zero. We don't have any. If we did have placements with Moscow Norodny in London, it would appear as part of our Soviet exposure, and we don't have any.

The CHAIRMAN. But in any event, if you did, you are saying it would be reported in the aggregate.

Mr. CLARK. Yes, as Soviet exposure.

The CHAIRMAN. It's probably very difficult for you to quantify, but I'd settle for some ballpark estimate, what would be your estimate of total Western commercial bank deposits in Soviet banks? I don't mean yours. You've said yours is zero. Do you have any idea, any wild ballpark figure about how much we're putting in the Soviet banks?

Mr. CLARK. The placements with Soviet banks would not be large, Senator Garn. We don't do much placement business with Soviet banks. They don't have a lot of branches in the West. The branches they do have are not large. There are lots of other ways of doing business with the Soviets, but the placements with the banks is not big business, with the Soviet banks. There may be some from time to time.

The CHAIRMAN. There was a rather well-publicized remark during the Eastern Europe debt crisis a few years ago by a prominent U.S. banking executive, who said he didn't care what sort of government a country had, as long as they paid their bills.

Is that a prevailing attitude, or is that just one banker opening his mouth when he shouldn't have?

Mr. CLARK. Can I plead the fifth amendment on that one? [Laughter.]

He happens to be a colleague of mine.

The CHAIRMAN. I understand that.

Mr. CLARK. You understand. I have to live with him, too, you know. [Laughter.]

It was a kind of an unfortunate misphrasing, I would say, and it certainly is not a widely held opinion, and he doesn't really hold that opinion. It was an unfortunate——

The CHAIRMAN. Mr. Clark, you said in your written statement that those banks involved in lending to the Soviet bloc are reluctant to engage in general purpose, medium-term lending.

Isn't it true, however, that the loan syndication to East Germany this spring was more than doubled, due to oversubscription by banks that were so eager to participate?

Mr. CLARK. Yes, but very largely non-U.S. banks, Senator Garn.

The CHAIRMAN. But nevertheless, there are a lot of banks out there that are eager to get involved?

Mr. CLARK. There certainly are, but, you know, as I say, the U.S. component of that is normally less than 5 percent and very rarely as much as 15 percent.

The CHAIRMAN. Gentlemen, I appreciate your willingness to be here.

I certainly do not think that this bill, in granting the authority to the President to make these kinds of decisions, is out of line at all. I personally would rather go further than that. I do think that when we are talking about commercial transactions that do involve foreign policies, both of you said, you shouldn't be involved in foreign policy, I do think that is an area that clearly is the Government's responsibility, and giving a President—and I say a President, because, obviously, we're going to have a new one in 3 years, due to the Constitution, whatever President is there, I think this gives him a tool to evaluate a particular situation and be able to act, and I don't see why we treat money differently than anything else that we grant powers to him under the Export Administration Act.

So I think it is a reasonable approach in an attempt to try to solve this problem.

But in any event, I thank you for your willingness to be here.

Mr. **McDonough**. Thank you.

Mr. **Clark**. Thank you, Senator.

The **Chairman**. The committee is adjourned.

[Whereupon, at 12:27 p.m., the hearing was adjourned.]

[Resonse to written questions of Senators Dixon and Proxmire follow:]

WILLIAM J. McDONOUGH
Executive Vice President and Chief Financial Officer
First Chicago Corporation

First Question from Senator Dixon:

There is already authority to control capital flows to any nation where the security interests of the U.S. are at stake or our economic stability is at risk. Do you believe this authority contained in IEEPA is adequate to deal with any foreseeable situation where the Government might feel it necessary to impose controls?

Response of Mr. McDonough:

Yes. The U.S. experience in imposing restrictions on capital flows under the International Emergency Economic Powers Act (IEEPA) in the cases of Iran and Nicaragua indicates that the authority contained in that legislation is, in fact, adequate to deal with any foreseeable situation where the Government might believe it necessary to impose such sweeping controls.

It is possible that the enactment of S. 812 might create ambiguities vis-a-vis the IEEPA that could cloud the authority contained in the latter.

Second Question from Senator Dixon:

Do you believe it would be wise to try to control capital flows routinely under the Export Administration Act as we control the exports of products and many services?

Response of Mr. McDonough:

No. Capital flows are strategically neutral. Unlike the provision of sensitive goods and technology to the Soviet Union and its allies, capital flows do not damage the security interests of the United States and its allies. Therefore, capital flows should not be controlled as a matter of routine. In fact, the very existence of such controls could well hinder trade in nonstrategic goods that is beneficial to our country.

Third Question from Senator Dixon:

If we were to enact S. 812, would its effects be limited to the Eastern Bloc countries, or would it have impacts on the competitive position of U.S. banks in markets around the world?

Response of Mr. McDonough:

We believe that S. 812 would make no meaningful contribution to preventing the Soviet Union and its allies from obtaining sensitive goods and technology. We believe that this would also be the view of many of this nation's trading partners around the world. And, it is our assessment that enactment of S. 812, with its imposition of controls on a nonstrategic item (i.e., capital), would raise questions throughout the world about our country's reliability and credibility as a supplier of goods and capital.

Fourth Question from Senator Dixon:

Do you believe S. 812 would have any impact on U.S. industrial and agricultural exports to the Soviet Union and other Eastern Bloc countries? Would it have any impact on our exports to countries not part of the Soviet bloc?

Response of Mr. McDonough:

We believe that the enactment of S. 812 could undermine the efforts of the President to expand peaceful trade with the U.S.S.R. It might be noted that last year American exports to the Soviet Union reached a value of $3.3 billion. (American imports from that country were only $500 million.) U.S. agricultural exports amounted to $2.8 billion and, U.S. exports of machinery and equipment totaled $110 million. (The remainder of American exports to the U.S.S.R. were accounted for by miscellaneous items.)

The Soviet Union is one of the few nations with which the United States has a positive trade balance. And the Soviets could easily purchase from other nations the industrial and agricultural items that the U.S. currently exports to the U.S.S.R. Before the imposition of the 1978 grain embargo, the United States accounted for between 50 percent and 70 percent of the Russian grain market. America's share has since dropped to less than 40 percent.

With regard to exports to countries that are not part of the Soviet Bloc, I would note, as I did in my response to your third question, that we believe that the enactment of S. 812 could undermine the perceived reliability and credibility of the United States as a supplier.

WILLIAM J. McDONOUGH
Executive Vice President and Chief Financial Officer
First Chicago Corporation

First Question from Senator Proxmire:

The National Bank of Washington in its June 1985 publication, International Review stated, "There are reasons to believe the six Eastern European countries will be tempted again to borrow from the hard currency areas. One reason is that the Soviet Union has demanded that they provide it with their highest quality machinery and industrial consumer goods, as well as food, precisely those items they would want to sell to the West for badly needed convertible currencies."

Don't you think, if that analysis is correct, that it would increase political tensions between the Soviet Union and its Eastern bloc allies if our banks did not step in and provide the hard currencies needed by these Eastern European countries. Wouldn't that be in our national interest, if it helped weaken the Soviet hold on Eastern Europe?

Response of Mr. McDonough:

It would, of course, be in the interests of the United States if the Soviet hold on Eastern Europe were to weaken. But it is questionable whether refusing to lend hard currencies to Eastern European countries would bring that about.

Perhaps, as your question suggests, "it would increase political tensions between the Soviet Union and its Eastern Bloc allies if our banks did not step in and provide the hard currencies needed by those Eastern European countries." However, events in Eastern Europe in the last several years do not indicate that "increased political tensions" lead to "weakening the Soviet hold."

In fact, historical evidence suggests that abrupt increases in tension between Eastern Bloc nations and the U.S.S.R. lead to the tightening of Russia's grip on its satellites. Examples are, of course, Hungary, Czechoslovakia, and Poland.

We agree with the view that access to Western capital markets provides Eastern European countries with economic options that make it possible for them to establish some degree of independence from the Soviet Union.

Second Question from Senator Proxmire:

In February of 1982, Felix Rohaytyn, a senior partner at Lazard Freres and Company said, "If the West refuses to provide further credits to Eastern Europe, the Soviet Union will have to do so ... [this] will put great additional economic pressure on the Soviet Union at a time when its own economy is faltering, and the burden of defense spending and overseas commitments must be heavy." He noted that this could mean the Soviets might have to retrench elsewhere - "possibly armaments or by a recognition that accommodation with the West is preferable."

Do you agree with that analysis? And if not, why not?

Response of Mr. McDonough:

We do not agree with Mr. Rohaytyn's conclusion.

It is clear that the Soviet Union attaches a very high priority to the achievement of its defense and other foreign policy objectives. Therefore, it is doubtful that any financial constraints caused by reduced lending to Eastern European countries (or to the Soviet Union itself, for that matter) would have any significant impact on Soviet military spending. Similarly, it seems quite unlikely that financial constraints associated with any such reduction in lending could influence such a fundamental decision as to whether or not to see further accommodation with the West.

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George J. Clark
Executive Vice President

December 23, 1985

United States Senate
Committee on Banking, Housing and Urban Affairs
ATTN: Mr. Edward Malan, Committee Editor
Washington, D.C. 20510

Dear Mr. Malan:

As requested in Senator Garn's letter of November 7, I am pleased to forward herewith my responses to questions submitted by members of the committee during my recent testimony concerning S. 812, the proposed Financial Export Control Act. I regret that rather extensive travel has delayed the response, and trust it will still be useful.

Sincerely,

Citibank replies to questions for the record

I. From Senator Alan Dixon:

- The Treasury Department, in its draft letter to the Committee on S.812, argued that:
    1) because money is fungible, it is very difficult to unilaterally impose effective international controls on the transfer of capital;
    2) the attractiveness of the U.S. financial markets as an outlet for financial investments by foreigners is due in no small part to the absence of any U.S. exchange controls; foreigners might assume S.812 represents a shift away from that policy, and therefore shift assets out of the U.S. with resulting adverse impacts on U.S. interest rates; and
    3) unless specifically limited to banking offices located in the U.S., the bill could raise problems with respect to the extraterritorial reach of these controls.

  Do you share Treasury's concerns?
  ANSWER: Yes.

- The Defense Department, in its letter to the Office of Management and Budget supporting S.812, asserts that U.S. banks have been offering loans to the Soviet Union and other Eastern Bloc countries at interest rates well below those offered by European banks. Do you agree with the Defense Department's analysis?

ANSWER: No. Rates have generally been driven lower by the non-U.S. banks which dominate this market, as I mentioned in my testimony. Comparisons of rates recently must take into account that trend, which of course will reflect lower rates in recent transactions regardless of which banks managed them or participated in them. Further, while some U.S. banks have played a merchant banking role in these transactions, earning fee income, the overwhelming share of the "loans" (i.e., the actual level of the participations in the credits) has come from non-U.S. banks -- precisely because of foreign banks' willingness to assume these risks at lower returns.

o The Defense Department also argues that by borrowing from United States banks, countries such as East Germany can avoid making concessions on issues such as immigration and human rights which are often a part of west European loan agreements with the East. How do you respond to this argument?
ANSWER: The argument confuses government loans with private commercial bank loans. Their reference is, I believe, to certain loans of the West German government to East Germany. Commercial banks are not, in general, the appropriate institutions to decide upon and effectively impose the kinds of political conditions which are sometimes the basis on which loans are extended by governments.

o The Defense Department believes that S.812 is warranted in that "restricting loans to Soviet Bloc nations would limit the amount of hard currency available to those nations to finance their foreign adventures and purchases (both legal and illegal) of western technology." The letter goes on to state that "even a small reduction in the level of hard currency available to the Soviet will require the Soviet Bloc to make more difficult choices between competing demands." Do you believe S.812 would limit, even to a small degree, Soviet Bloc access to hard currency?
ANSWER: Not enough to have even the results the Defense Department describes.For the reasons I have mentioned, any impact would be minimal and, in my judgment, the resulting gap would be quickly absorbed by other suppliers of credit in what we must remember is a global marketplace.

II. From Senator William Proxmire:

- You make the point on pages 6 and 7 of your testimony that it makes no sense to control U.S. bank loans to the Soviet Bloc because banks from other countries would just do that business in our absence. Is that also your bank's policy with regard to South Africa? If not how do you distinguish the two cases?
  ANSWER: In general, unilateral action has limited effect whether applied to South Africa or to the USSR. The two cases are, however, fundamentally different: (a) The USSR has a high credit rating in the global marketplace, based upon debt-servicing performance, while South Africa has unilaterally declared a moratorium on debt-servicing payments. (b) As to who can effectively exert pressure for policy changes, the U.S. banks have little exposure to the USSR, as I have noted, and their share would be easily replaced by non-U.S. banks, none of whose governments are likely to agree to impose economic sanctions of this type; in contrast, the U.S. has been joined by some other major governments in exerting pressure on South Africa. (c) Citibank stopped lending to the South African government years ago. However, we continue to operate a local-currency bank within South Africa because we still believe we can justify those risks on a credit basis and make a more positive contribution toward change in that society than we could by withdrawing from it. In contrast, the USSR permits no such opportunity for foreign-owned banks to provide local-currency financial services within its economy.

- In response to a question I asked the State Department in 1982 when we had our hearing on the Polish Debt crisis, the State Department said, "If the Soviet hard currency position were further harmed by a loss of Western credits, the

leadership would be likely to adopt domestic economic policies restricting private consumption in order to allow for continued growth in defense spending. While Western credits may not directly strengthen the Soviet military, they do make economic decision-making easier for the Soviet leaders." Do you agree with that analysis of the Department of State? If not, please explain the basis of your disagreement.
ANSWER: The statement cites "Western" credits, not simply the relatively small share extended by U.S. banks which has been the focus of the present hearing. I agree with the statement, which merely makes my point that, while multilateral "Western" action could have significant impact, unilateral U.S. action such as that contemplated by S.812 would have virtually none.

- On page 6 of your testimony you state that you defer to our political officials in the setting of our foreign policy goals. Why then do you oppose granting the President the discretionary authority to regulate bank loans to the Soviet Bloc? He, as our top political official, would not need to use the authority unless he felt it would achieve some policy goal -- but the authority would be there if he needed it to achieve such goals. Please explain this apparent discrepancy between your prepared testimony and your opposition to S.812.
ANSWER: You correctly cite my statement, which defers to others as to our foreign policy goals. This hearing, however, is focussed on one proposed instrument for achieving foreign policy goals, and, since that instrument happens to lie in the financial area and since I have some experience in that area, my point is that this particular instrument would be ineffective.

CONTROLS ON THE EXPORT OF CAPITAL FROM THE UNITED STATES

WEDNESDAY, DECEMBER 4, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., pursuant to notice, in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Cranston, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

The purpose of the hearing this morning is to continue the hearing that we held earlier on the Financial Export Control Act. This bill would give the President nonemergency authority to control transfers of capital to countries that have been identified as threatening our security.

When Senator Proxmire and I introduced this bill earlier this year, a $500 million loan, syndicated by United States banks and at very generous interest rates, was being extended to East Germany. I questioned at that time the very generous interest rates, rates far better than the average American could obtain to buy a home, finance a farm, or start up a business. I asked why lending was being renewed to the Soviet bloc countries after United States banks and nearly all other Western banks had left that market several years earlier. What had changed to make the market attractive? Eastern European countries were still following very destructive economic practices; they were still suffering from energy problems; and they still had trouble generating hard currency.

In the area of foreign policy, what had changed? These countries continued to fund terrorism around the world. At home, their disregard for human rights remained as bad as ever. Was Solidarity an officially recognized union in Poland? No, it was still outlawed, and in East Germany, a Solidarity Union has never even been allowed to get started.

When the committee held its first hearing on this bill, 6 months later, a second United States syndicated loan to East Germany for $600 million, was being made, along with a $200 million United States syndicated loan to the Soviet Union.

What had changed since the spring when the bill was introduced? Nothing. Nothing but more of the same, except that United

States banks were no longer lending to South Africa because that Government oppressed its citizens.

I made the point very strongly at that time that we should quit having double standards. We look at the oppression in these countries that we are now making loans to and certainly they are at least as oppressive, if not in many, many cases far more oppressive than the Government of South Africa.

Last week, the national papers reported yet another loan has been negotiated by United States banks to provide the Soviet Union with up to $400 million in trade credits. By itself, this loan would not be likely to cause concern. It is tied to specific purchases of agricultural products. It is a short-term trade credit, the functional equivalent of a cash transaction in international trade. Yet the bankers made it clear that they saw this loan as opening the door to ever increasing lending to the Soviets. One banker was quoted in the New York Times as saying, "this kind of lending is going to get bigger."

Does this kind of lending have any effect on our foreign policy or national security? If it does, what role can the President play in it? The President has authority to control exports of goods and services, but he has no nonemergency authority to control capital transfers. Yet international lending, on the scale of hundreds of millions of dollars, can have as much or more of an influence on our security and foreign policy as can exports on goods and services.

Without this authority the President either must wait for another Polish debt crisis to occur before invoking his emergency authority, or he must abuse his emergency authority by using it when an emergency does not exist. What is needed is limited, but flexible, authority to control capital transfers to those countries already identified as security risks so that crisis situations can be avoided and the integrity of the President's emergency authority preserved. That is what this bill would provide. The bill is flexible; it does not prescribe any action. It is not limited to national security related situations.

It has been said that money is fungible, that one bank can lend it to another, and soon the money is where we don't want it to be. The problem is not, however, that someone is trying to smuggle dollars into the Soviet Union. These are not computer chips or radar parts. It is the aggregate that causes concern. We are not yet worried that the Soviets will try to reverse engineer our currency and print their own dollars. Banks make these loans to obtain a profit, and they are multimillion dollar loans. When they have to lend the money to another bank to make the loan, they lend at the very low interbank rates and the profit disappears. The banks won't do it. They will lend their money somewhere else, where a profit is to be made. So controls on bank loans are clearly enforceable.

It is true that United States banks are not the only ones in the Soviet market. But when United States banks halted lending to South Africa this summer, for example, the result was a financial crisis. That crisis made it clear that when U.S. banks close their credit lines, other banks become cautious. U.S. banks exert a powerful psychological influence on world lending patterns. Where

U.S. banks are not in a market, lending in that market is far from normal. Allied governments may not join in controls, but their banks will take notice.

The legislation is very modest, it is reasonable. It fills a major gap in the President's authority to conduct foreign policy on a day-to-day basis. Without it, the President is crippled in dealing with one of our most important foreign policy relationships.

I would add this legislation is not mandatory for the President, and I fail to understand why the administration would oppose it, which I have been led to believe they will, because it gives the President discretionary authority. It does not mandate him to do anything, but gives him some tools that I think would be very useful in this area.

I look forward to the comments from our very distinguished witness.

Senator Dixon, do you have any opening comments you wish to make?

OPENING STATEMENT OF SENATOR DIXON

Senator Dixon. Thank you, Mr. Chairman.

Ordinarily I put my statement in the record, but because of my interest in this, I am going to indulge myself, if the Chair doesn't mind, by making a very brief statement.

I am pleased to be here this morning as the committee conducts its second day of hearings on S. 812, the Financial Export Control Act.

I am particularly pleased that the committee will be hearing from representatives of the Treasury Department. I am sorry Treasury was not able to testify at the first hearing on this bill in September.

I hope all the witnesses today will address the most fundamental question raised by this bill. Will it work? I understand and support the idea that there are circumstances where we might not want to permit loans to be made by our banks to the Eastern bloc.

I am concerned, however, about indicating to our international competition that once again we are inclined to go it alone and impose controls without regard to what they are doing. We have tried that before and it does not work.

Let me use an example that I have used in this committee before, Mr. Chairman, the case of Caterpillar Tractor. Caterpillar in my State used to have virtually all of the Soviet market in crawler-type tractors, and that market was a huge one, second only to the United States market. However, after the pipeline controls were imposed, Caterpillar was essentially frozen out of the Soviet market.

The Russians continued to be able to buy tractors abroad, however. They simply purchased Komatsu tractors from Japan, and they were able to continue with the pipeline that controls attempted to stop.

The net result of the controls therefore was that the Russians were perhaps mildly inconvenienced, a major Japanese firm was greatly benefited and the international competitiveness of a major United States firm, Caterpillar Tractor, was serious compromised.

Now there are differences between tractors manufactured by different companies, but there are no differences at all between one dollar bill and another. Further, it is not only U.S. banks that can lend dollars to the Eastern bloc, foreign banks also have this ability because the world is awash in dollars.

I hope all of the witnesses today will tell the committee what they believe control authority of the type provided by S. 812 might achieve given the fact that our international competition could step in and substitute for U.S. banks if we impose controls on our own.

I would be interested in learning how those controls might be effective. If we are able to impose controls for only symbolic reasons rather than with any hope in denying the target of controls access to capital, then we should know that now and should be considering the question of whether to act on S. 812 with that fact in mind.

And I might say, Mr. Chairman, that I have read the statement by David C. Mulford, the Assistant Secretary of the Treasury for International Affairs, and it reflects generally my point of view.

I am pleased to see that the President has indicated his opposition and the opposition of the administration, and I would simply call the conclusion of the statement by Mr. Mulford to the attention of my colleagues on this committee:

> Although the authority contained in S. 812 is discretionary, it would have a chilling effect on the President's efforts to encourage mutually beneficial nonstrategic trade, but without producing any concomitant benefits to our efforts to control the flow of strategic technology to Soviet bloc countries. The message this legislation would send runs directly counter to the message from Geneva and would create confusion among our allies concerning our policy toward the Soviet Union.
>
> The administration strongly opposes new authority to monitor and impose controls against the bloc and possible other countries because in our view such action would not achieve the strategic results intended. However, it would damage U.S. financial and economic interests as well as relations with our allies who will resist attempts to persuade them to cooperate. It would be a perverse effect if in an attempt to injure the bloc we instead weakened the Western Alliance.

I thank the Chair.

The CHAIRMAN. I would say to my good friend from Illinois that he is correct in that the Yamal pipeline was not well handled, but I don't think we can simply blame it on unilateral controls.

I have been very much involved in these areas for a long, long time, and whether it is high technology or whether it is money, the excuse I have now heard over and over again from this administration, the Ford administration and the Carter administration is that if we don't do it, somebody else will.

So essentially the stumbling giant can't ever do anything, because somebody else will take our place. That has often been true because our allies are gutless as well and because we have double standards.

I get back to what I said in my statement about the treatment of South Africa, and don't anybody misunderstand me, I do not approve of apartheid, I don't understand it, I don't understand the Government of South Africa, and I certainly understand the domestic politics of what is going on with our controls, our prohibitions and so on.

But some day, and this is not directed at my friend from Illinois, but some day somebody has got to explain why the Russians are so darned nice. They have got to explain the treatment of Jews and the lack of immigration, people in political prisons, they have got to explain what has happened to Lech Walesa and those in Poland.

That double standard really offends me, Senator, and I know it is not yours. So don't misunderstand my remarks. I am not responding directly to you on that point.

Some day in our political system somebody has got to have the nerve and the courage to stand up to that selective use of American controls on export of technology and money to certain governments, but not to others who rape and violate the political privileges and free agency of their citizens.

Because we are supposed to be nice and because we have got a charade going on over there in a summit, we can't do those things. We can't even say to the Soviet Union that they are an evil empire. Why not? They are. Good Lord they are. They have only killed, what, 30 or 40 million of their people under Stalin. Talk about violation of human rights! And it continues, it continues in the Eastern bloc countries. You have a wall in Berlin that is still there. It goes on and on and on.

I don't know why we can't apply the same controls to those countries uniformly for violators of human rights wherever they are rather than just selectively picking out one country.

So I am not surprised at the administration's position on this. We say it is the President's position, but I would be willing to bet if I called Ronnie this morning and said what is your position on this, he hasn't heard of it. This is coming out of the bowels of Treasury. We know how the system works down there and Ronnie hasn't heard of it yet.

I expect that if we sometimes went around the bureaucracy, I think I would know what the President's basic instincts are and what he would feel like doing, but he will be shielded as usual.

Well, I am sorry, Senator. Again, I am not responding to what you said, but I think we need to look back to the Yamal pipeline of the Carter administration who wouldn't do anything about it, or the Reagan administration who fiddled around for 1½ years before they decided to impose controls and then the results you talk about took place. It was far, far too far down the line to stop the Yamal pipeline at that point.

I spent 1½ years trying to get him to do something. But I happen to think that in that case something could have been done if it had started much earlier. Maybe if President Carter had had some discretionary authority to look into that, maybe it could have been worked out. And when we talk about trade legislation on textiles and protective legislation, you are right, Komatsu ran in there and sold those tractors rather than Caterpillar.

Well, why don't we ask them to find out how many Toyotas they can sell in Moscow? They continue to export 24 or 25 percent of our domestic automobile market, they produce unemployment in this country, in your State and in the automobile manufacturing States, and then they will go and sell tractors. I don't think the market is too good for Toyotas, Nissans, and so on in Moscow, or in Poland, or any place else.

We simply won't take full steps, Senator, and until we do, what you say is true. We will be replaced by our friends and allies just like the grain embargo. It didn't work because Argentina and

Canada, our good friend to the north, wouldn't participate. Their greed for their own sales went on and on and on.

That isn't going to stop me from continuing to make the speech I have been making from this podium for years, that we ought to get a little more blunt in our treatment of some of our allies and say, "we want your cooperation." I am going to start voting for all sorts of protectionist things, against my full, basic political instincts and start shooting shells across people's bows. Maybe it won't work, but you get to a point where you are so frustrated with the stupidity of our foreign policy that, at least, you have to keep trying.

Senator MATTINGLY. Maybe you can help us override the textile veto.

The CHAIRMAN. I will.

Senator MATTINGLY. Good. Thank you. [Laughter.]

The CHAIRMAN. It is a miserable piece of legislation. It is the worst protectionist piece I have ever seen. It is poorly written. I voted for it for the reasons that I have stated and I will vote for the override, admitting that it is a bad piece of legislation.

Senator DIXON. I just want to say that I am delighted to have the chairman's adrenaline pumping so well so early in the morning. [Laughter.]

The CHAIRMAN. Well, it got started on that Farm Credit bill yesterday, Senator. [Laughter.]

Senator MATTINGLY. Senator D'Amato wants to pump a little also. [Laughter.]

The CHAIRMAN. Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Senator, I would like to pump a little because at the Helsinki Commission where we are going to hold some hearings at 10 o'clock, I will be chairing on the Afghanistan problem and the violation of any human rights or standards by the Soviet Union.

The CHAIRMAN. I wonder what we would do to South Africa if they had done that to Afghanistan?

Senator D'AMATO. Mr. Chairman, I am going to ask that my statement be included in the record as though read in its entirety, and simply say that as a cosponsor of this legislative initiative of yours and Senator Proxmire's it seems to me that there is another avenue which Treasury and the Federal Reserve over the years has done an absolute miserable, terrible job.

I wonder why some of the people that made some of the loans have been able to get away with reporting those loans year after year as profits. I think if the average corporation of America did it, that corporate's executives responsible would have been indicted for fraud. Yet no one says anything and no one did anything.

And all the journalists over there, they know it takes place. Yet no one has ever looked into the absolute scandalous, shocking lack of whether it is the Federal Reserve, the Treasury, the media, the Congress doing nothing with a litany of bad debt that were made whether to Poland or to other foreign nations and then reported it to the stockholders as in many cases at the end of each year's record-breaking profits.

So they compound this incredible situation by making these loans in many cases to nations who really should not be getting them.

And, second, in some cases to the poorest credit risks of all, and we the American people in the final analysis are going to be picking up the tab.

And going back to my other point, it is absolutely incredible that the American businessmen reported earnings where there were indeed losses. My good friend, Senator Proxmire, knows exactly what could and should and would probably take place within the SEC, the Justice Department, and all other avenues. And yet nothing has ever been done or taken place.

Maybe I am going to ask the GAO to look into that aspect, if you would like to join with me. This is something that has troubled me, absolutely troubled me and perplexed me, and yet now we continue along this vein to make these loans. I dare say I doubt if many of them ever get paid back. So not only do we make them at preferable interest rates, but the countries who in many cases shouldn't qualify under any standard if we are going to look at human rights violations, et cetera, but even if we look at the economic situation, they are probably bad loans given the past track record and that record has been miserable.

Mr. Chairman, I am going to support this legislation. There may be shortcomings, but nothing is really perfect. I think the real shortcoming is just in allowing this travesty to continue and be quiet and say all is well when that is not the case.

Thank you, Mr. Chairman.

[The complete prepared statement of Senator D'Amato follows:]

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Mr. Chairman, I appreciate your scheduling of today's hearing in which we will address the important issues regarding the extension of U.S. credit to Warsaw Pact countries. I share the frustration that is felt not only by the cosponsors of this legislation, but by many Americans who are outraged that we provide vitally needed currency in the form of loans to East European Communist nations. Our sense of outrage is further heightened by the illegal transfer of technology to these nations; an act often facilitated by Western loans.

The timeliness of this hearing is demonstrated by the recent release of an updated report by Secretary of Defense Weinberger on the acquisition of military-significant Western technology by the Soviet Union. This report details the extent of Soviet successes in unlawfully acquiring vital technology from the United States for its arms buildup. The United States has kept a technological edge on the Soviet Union, but we are losing our advantage due, in part, to the unlawful transfer of advanced and sensitive technology to Soviet bloc nations. To obtain this technology, the Soviets and their client states must pay for the technology with foreign currencies that are not readily available in nations dependent upon nontraded currencies. S. 812, the Financial Export Control Act, addresses this growing and increasingly threatening problem.

S. 812 addresses the problem attendant to providing Eastern bloc nations with foreign currency by giving the President the power to control the transfer of capital to these nations. This will expand similar Presidential powers under the International Emergency Economic Powers Act.

Earlier in this decade, U.S. banks were the first to curtail lending to Eastern bloc nations. The termination of these loans was due, in part, to internal political pressure in the form of human rights concerns and to the fact that these countries were poor credit risks. Recently, however, U.S. banks have resumed lending to Eastern bloc nations. Apparently, U.S. banks have determined that these countries are now better credit risks. The resumption of loans to Eastern bloc nations cannot be tied, however, to an improved human rights record. As Chairman of the Helsinki Commission on Human Rights, the resumption of lending indicates that human rights violations play little role in determining a nation's eligibility for U.S. credit and capital. We must set some consistent standards to determine the conditions that must be present before we provide loans to these nations. Recently, the President, under pressure from Congress, banned new bank loans to the Government of South Africa because of its regrettable human rights record. United States policy in this area appears inconsistent if exceptions are made for nations like the Soviet Union which routinely trade in goods produced by slave labor and ruthlessly persecutes its Jewish citizens and dissidents.

Clearly, the issues regarding the lending of U.S. capital to Eastern bloc Communist nations are not easily resolved. On the one hand, Western industrialized nations want to foster trade with Warsaw Pact countries to ease world tensions and improve the world economy. Alternatively, we do not want to give to the Soviet Union and its satellites the means by which they can illegally purchase our technology.

I commend Senators Garn and Proxmire for bringing these issues to the attention of this committee and the Senate and offering a viable solution to the problem. I look forward to the testimony of our witnesses.

Senator **Garn**. Thank you, Senator D'Amato.

Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator **Proxmire**. Thank you, Mr. Chairman.

I will be brief. I know we are all waiting to hear from Mr. Mulford and the other outstanding witnesses that we have today. So I will just take a minute or two.

Mr. Chairman, this is the second day of hearings we have had on S. 812, the National Export Control Act, the bill I am cosponsoring with you, Mr. Chairman. The bill is not complicated. It would amend the Export Administration Act and give the President the authority to control loans and other extensions of credit from American banks and corporations to the Soviet Union and to Eastern bloc allies.

Mr. Chairman, this bill would not prohibit loans to the Soviet bloc. It simply authorizes, it does not direct, the President to control transfers of capital to countries against which we maintain national security export controls, that is the Soviet bloc countries.

This bill, if enacted, would enable the President to more carefully review extensions of credit to the Soviet bloc in order to ensure that such loans are handled as part of our overall strategic relationship with the Soviet Union.

You can be sure that the Soviet Government uses its trade and credit deals with the West for strategic purposes. So, too, should our executive branch have the authority to review and approve credit deals with the Soviets just as it now approves what type of goods our manufacturers can export to them.

Why should our banks be exempt from requirements we impose on other businesses to ensure our country's well-being?

In our first hearing on this bill on September 26, Mr. Richard Allen, formerly President Reagan's Chief Assistant for National Security Affairs told us he endorsed this bill. He endorsed this bill, and why, because he said we presently have no effective means to stem the flow of money and credits to countries that pursue policies that are inimical to U.S. interests and that may jeopardize American lives and property.

Nevertheless, witnesses from the First Chicago Bank and City Bank, both of which are now making loans to the Soviet bloc, told us they did not support enactment of S. 812. Their views were similar to those voiced by David Rockefeller in explaining why his bank made loans to Marxist governments. That is, and I quote Mr. Rockefeller, he said "We have found we can deal with just about any kind of government provided they are orderly and responsible."

Now it is clear that our banks take an apolitical view of their role. They will not consider our overall national interest in their credit decisions. This is precisely why the President should have the authority conferred on him by S. 812, that is to review and, if need be, regulate extensions of credit to the Soviet Union and its allies.

Mr. Chairman, again I commend you for sponsoring this bill and for scheduling this second hearing on it. I look forward to hearing all our witnesses, but particularly those from the administration who have been invited to give us the President's view of this legislation.

Thank you.

The CHAIRMAN. Senator Mattingly.

OPENING STATEMENT OF SENATOR MATTINGLY

Senator MATTINGLY. Thank you, Mr. Chairman.

I would just like to say I am also proud to be a cosponsor of S. 812. I think the committee has worked long and hard to provide this country with a modern and reasonably efficient export control policy. I think we have sought to provide a system which protects the national security of this country while taking into consideration the realities of today's world trade environment.

I want to help U.S. high technology to retain its state-of-the-art preeminence, but we should not stand by and watch the U.S. technology handed to our adversaries on a silver platter and a mockery being made of U.S. export control policies.

It seems to me that we have been robbing Peter to pay Paul, on the one hand we have intensified efforts to halt the flood of technology leaks to the Eastern bloc while the hard currency is easily available to the same nations who then use it to buy, either legally or illegally, U.S. technology and know-how.

I will just say that the process we are currently using just makes no sense at all. This bill puts some sense back into what I think we are basically trying to do. S. 812 is trying to restore some foreign policy dignity and some defense policy dignity and some trade policy dignity that we have lost.

If we are trying to retain the principles of freedom and peace here and promote freedom and peace and democracy around the world, I don't see why we shouldn't have full disclosure on this hard currency lending before it is effected.

What has been going on almost borders on the ridiculous, and I agree with all the points you made, Mr. Chairman. I think it is basic policy principles that we should be adhering to and we are not adhering to the basic principles of controls, or technology and or hard currency, the way we are presently conducting business.

If the capital controls currently being implemented by Executive order are legitimate I don't see why the administration doesn't wake up and support a similar policy as far as capital flowing into the Eastern bloc.

I wish I could be as articulate as my chairman on this subject, but I feel very strongly about it. I think it borders on the ridiculous that a piece of legislation like this doesn't just pass automatically and roll right over whoever the contrary bureaucrats are, down wherever they may be.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, thank you.

I look forward to hearing from the administration on your bill, Mr. Chairman, S. 812. If the goal of S. 812 is really to get at the transfer of technology, my concern would be that we have not done the job we should have done in rewriting and toughening the Export Administration Act.

And let the record show that Chairman Garn and this Senator did everything we could reasonably be expected to do to do that, but we were not able to persuade the House of Representatives or even the administration of the necessity for all the kinds of constraints on transfer of high technology to the Eastern bloc that we were concerned about.

While I think this kind of an approach is very much a second or a third best approach to tackling the problem as I understand it, it may be the only kind of approach we have, even if some might liken it to putting a tourniquet around the neck to stop bleeding at the arm.

So I am going to be interested in what the administration has to say. The Treasury Department that is here, my general sense, Mr.

Chairman, is that this really goes beyond the Treasury Department and the issue of capital controls and the philosophical concerns people may have in that regard because really, at heart, is the question of the enforcement through existing law of the Export Administration Act over controls that we apply directly to the transfer of technology.

My general sense is it would be nice to hear from the Commerce Department and the Defense Department as to whether they think they are doing a good job or not.

I have no further comments.

The CHAIRMAN. Well, I would say the Senator is absolutely correct. If you and I had been able to do the job that we had hoped to do on the Export Administration Act, after all those months and years of working on it, we wouldn't be here talking about this particular bill.

Senator Cranston.

OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. I would just like to say that I am very interested in this legislation. I want to make sure that we are not unduly restricting our capacity to be engaged in export that strengthens our economy, that enables us to cope with our balance of trade problem and that does not unduly aid those who are our adversaries in the world.

We have to be cautious on the latter point of giving aid to our adversaries, but we also have to make sure that we are not cutting off our own capacities and reducing our own economic viability by what we do. So that is one aspect of this legislation that I want to look at with extreme care.

The CHAIRMAN. Mr. Mulford, we appreciate your patience and also your courage after hearing most of the opening statements this morning and knowing of the internal debate that has gone on in the administration in trying to come up with a position. I don't know whether you drew the short straw and were the one sent up here to face us or not, but nevertheless, we appreciate your courage and will be happy to hear from you at this time. .

STATEMENT OF DAVID C. MULFORD, ASSISTANT SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS

Mr. MULFORD. Thank you, Mr. Chairman.

I am very pleased to be here and I am pleased to have the opportunity to appear before you this morning to discuss S. 812, the Financial Export Control Act.

I will respond to your request for Treasury's views on the administrative aspects of this proposal and also discuss the wider policy implications of this legislation.

PRESIDENT OPPOSES S. 812

As you may know, the President held a joint meeting yesterday of the National Security Council and Economic Policy Council, and after hearing views of the Cabinet decided to oppose this legislation.

S. 812 would amend the Export Administration Act [EAA] to give the President discretionary authority to use in nonemergency circumstances. If enacted, the President could prohibit, curtail, monitor, or otherwise regulate the export or transfer of money or other financial assets, the making of a loan or any type of credit, or an extension of credit, including supplying of funds through underwriting and distribution of securities, assisting in making a direct placement, or participation in the offering of securities to the government of any "controlled country".

The list of "controlled countries" currently consists of Communist countries, excluding Yugoslavia, but including China. Under the EAA "controlled countries" could include any other country that the President might add or remove from the list taking into account criteria set forth in the act and other factors the President considers appropriate.

The administration opposes such broad discretionary authority for use in nonemergency circumstances. We do not believe that the controls on international capital movements should be exercised except in the case of an international emergency that affects the national security of the United States or threatens the economic stability of the United States or the world. The existing International Emergency Economic Powers Act [IEEPA] provides adequate authority to deal with such emergencies.

We understand that the purpose of S. 812 is to limit or reduce bloc purchases of sensitive goods and technology. Although the President has decided to oppose S. 812, I want to assure you that the administration is in sympathy with your desire to control such trade. We believe, however, that there are better ways than capital controls.

Direct controls on U.S. exports of sensitive goods and technology are already in place and can be more efficiently regulated under the existing EAA. To that end we should enforce our existing export controls effectively to reduce the flow of technology and strategic exports. The optimal approach is to tighten multilateral enforcement of rules of the Coordinating Committee for Multilateral Export Controls.

As regard capital controls, the administration believes that the approach of S. 812 would not work and would hurt U.S. interests. I will try to explain why.

It has been U.S. policy to encourage mutually beneficial nonstrategic trade with the Eastern bloc. If we were to attempt to make financing impossible for trade in general, we would clearly be altering in a major way U.S. policy toward the Eastern bloc.

Because money is fungible and is used to finance most trade, capital controls are clearly too blunt a tool to achieve the specific purpose. In any case, they would not be effective in denying hard currency to bloc nations.

Attempts to regulate broad capital flows historically have been ineffective. Capital controls are totally ineffective when they are unsupported by those in the market, again, because money is fungible and tends to find ways to move freely.

It is even more difficult to impose unilateral constraints on the aggregate flow of credit to a particular country. U.S. controls in this case would be unilateral because there is no consensus for coordinated controls on loans to controlled countries. In fact, our European allies place a high priority on maintaining normal trade and financial relations with the Eastern bloc as a means of fostering détente. Accordingly, they strongly reject proposals to restrict trade or financial flows as economic warfare, as we have learned in the recent past. To pursue controls against the clear policies of our allies would be counterproductive.

UNILATERAL CONTROLS WOULD INVITE RETALIATION

Unilateral controls by the United States would also invite retaliation from our allies, who would strongly resent any attempt to enforce such controls on the foreign branches of U.S. banks. Unless specifically limited to banking offices located in the United States, legislation imposing or authorizing financial controls raises such problems with respect to their extraterritorial reach.

Controls would also invite retaliation from bloc countries which probably would direct their hard currency to the export sales of our competitors. Our trade flows in general would certainly be adversely affected and we would be at a disadvantage in financing whatever export business remained for our producers. We would no doubt lose sales of grain and other commodities which would penalize U.S. farmers. In general, our economic growth and employment would be reduced.

Capital controls would also damage U.S. capital markets. The impact is even worse in nonemergency circumstances. Controls, even in critical emergencies seriously damage foreign perceptions of the United States as a nation of free markets. Part of the dynamism of our economy is reflected in its ability to attract foreign capital which seeks safety in an often uncertain world.

Unnecessary controls would be viewed by foreign interests as politically capricious. They would weaken the perceptions that the United States is a good place to invest, therefore undermining our ability to attract foreign investment. Controls would also weaken our ability to persuade other nations to remove barriers they impose to the free flow of capital.

I would now like to comment on what is perhaps the most serious weakness of the controls proposed in this legislation. The fact that they would be totally ineffective. I have already mentioned that our allies would not support such controls. Therefore, we must look to our own market share to determine the potential effect that controls imposed unilaterally by the United States would have.

U.S. SHARE OF TOTAL MARKET IS BETWEEN 6 AND 7 PERCENT

In this case the U.S. banks have a very small share of the total market. Measured in terms of total exposure to bloc nations, U.S. banks share is between 6 and 7 percent. Exposure takes into account commitments to lend as well as outstanding claims and incorporates only assets for which banks are at risk. U.S. banks exposure, which declined to $2.6 billion in June, compares to the exposure of non-U.S. banks of roughly $40 billion.

At times the syndications led by U.S. banks are reported as lending by U.S. banks when in fact the end participation of U.S. banks as lenders has been very small. While there has been a modest resumption of lending by U.S. banks to some bloc countries, on balance outstanding loans of U.S. banks have continued to decline.

It is worth noting that net lending, that is new loans less repayments, in the first half of this year was by non-U.S. banks. Net lending to the bloc was on the order of $3 billion, and all was provided by non-U.S. banks. The outstanding claims of non-U.S. banks increased to a level of $49.3 billion. The claims of non-U.S. banks are larger than their exposure because their exposure excludes, but total claims include, loans guaranteed by other institutions, particularly official export credit agencies.

In the same period, the claims of U.S. banks on Eastern bloc countries fell overall by $156 million to a level of $2.3 billion. The decline indicated that bloc repayments in that period still exceeded the amount of any new U.S. bank loans.

If we imposed controls or advised our banks to refrain from lending or managing financing for the bloc, other countries would be more than willing to see their banks assume our banks market share.

You asked about administrative aspects of this bill. Should the bill be enacted, Treasury's Office of Foreign Assets Control [OFAC] would be responsible for administration of any controls imposed. OFAC presently administers economic sanctions measures authorized by the Trading with the Enemy Act and the IEEPA against South Africa, Nicaragua, Cuba, Vietnam, North Korea, and Cambodia. Exactly what might be needed in terms of additional personnel would obviously depend on the contours of any specific controls imposed and cannot be predicted on the basis of the language of the bill itself.

The Presidential meeting in Geneva was an initial step toward a more stable and constructive East-West relationship. One element of such a relationship must be mutually beneficial nonstrategic trade. Although the authority contained in S. 812 is discretionary, it would have a chilling effect on the President's efforts to encourage mutually beneficial nonstrategic trade, but without producing any concomitant benefits to our efforts to control the flow of strategic technology to Soviet bloc countries.

The message this legislation would send runs directly counter to the message from Geneva and would create confusion among our allies concerning our policy toward the Soviet Union.

The administration strongly opposes new authority to monitor and impose controls against the bloc, and possibly other countries, because in our view such action would not achieve the strategic results intended. However, it would damage U.S. financial and economic interests as well as relations with our allies, who will resist attempts to persuade them to cooperate. It would be a perverse effect if in an attempt to injure the bloc we instead weakened the Western alliance.

Thank you very much, Mr. Chairman.

[The prepared statement of David C. Mulford follows:]

STATEMENT OF THE HONORABLE
DAVID C. MULFORD
ASSISTANT SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS
BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
DECEMBER 4, 1985

I am pleased to have the opportunity to appear before you this morning to discuss S. 812, the Financial Export Control Act. I will respond to your request for Treasury's views on the administrative aspects of this proposal, and also discuss the wider policy implications of this legislation. As you know the President held a joint meeting yesterday of the National Security Council and Economic Policy Council and after hearing views of the Cabinet decided to oppose this legislation.

S. 812 would amend the Export Administration Act (EAA) to give the President discretionary authority to use in non-emergency circumstances. If enacted, the President could prohibit, curtail, monitor, or otherwise regulate the export or transfer of money or other financial assets, the making of a loan or any type of credit, or an extension of credit, including supplying of funds through underwriting and distribution of securities, assisting in making a direct placement, or participation in the offering of securities to the government of any "controlled country."

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The Administration opposes such broad discretionary authority for use in non-emergency circumstances. We do not believe that controls on international capital movements should be exercised except in the case of an international emergency that affects the national security of the United States or threatens the economic stability of the United States or the world. The existing International Emergency Economic Powers Act (IEEPA) provides adequate authority to deal with such emergencies.

We understand that the purpose of S. 812 is to limit or reduce Bloc purchases of sensitive goods and technology. Although the President has decided to oppose S. 812, I want to assure you that the Administration is in sympathy with your desire to control such trade. We believe, however, that there are better ways than capital controls.

Direct controls on U.S. exports of sensitive goods and technology are already in place and can be more efficiently regulated under the exisiting EAA. To that end we should enforce our exisiting export controls effectively to reduce the flow of technology and strategic exports. The optimal approach is to tighten multilateral enforcement of rules of the Coordinating Committee for Multilateral Export Controls (COCOM).

As regards capital controls, the Administration believes that the approach of S. 812 would not work and would hurt U.S. interests.

I will try to explain why.

It has been U.S. policy to encourage mutually beneficial non-strategic trade with the Eastern Bloc. If we were to attempt to make financing impossible for trade in general, we would clearly be altering in a major way U.S. policy towards the Eastern Bloc.

Because money is fungible and is used to finance most trade, capital controls are clearly too blunt a tool to achieve the specific purpose. In any case they would not be effective in denying hard currency to Bloc nations.

Attempts to regulate broad capital flows historically have been ineffective. Capital controls are totally ineffective when they are unsupported by those in the market, again, because money is fungible and tends to find ways to move freely.

It is even more difficult to impose unilateral constraints on the aggregate flow of credit to a particular country. U.S. controls in this case would be unilateral because there is no consensus for coordinated controls on loans to "controlled countries." In fact, our European allies place a high priority on maintaining normal trade and financial relations with the Eastern Bloc as a means of fostering detente. Accordingly, they strongly reject proposals to restrict trade or financial flows as "economic warfare," as we have learned in the recent past. To pursue controls against the clear policies of our allies would be counter productive.

Unilateral controls by the U.S. would also invite retaliation from our allies, who would strongly resent any attempt to enforce such controls on the foreign branches of U.S. banks. Unless specifically limited to banking offices located in the

United States, legislation imposing or authorizing financial controls raises such problems with respect to their extraterritorial reach.

Controls would also invite retaliation from Bloc countries which probably would direct their hard currency to the export sales of our competitors. Our trade flows in general would certainly be adversely affected, and we would be at a disadvantage in financing whatever export business remained for our producers. We would no doubt lose sales of grain and other commodities, which would penalize U.S. farmers. In general our economic growth and employment would be reduced.

Capital controls would always damage U.S. capital markets; the impact is even worse in non-emergency circumstances. Controls, even in critical emergencies, seriously damage foreign perceptions of the United States as a nation of free markets. Part of the dynamism of our own economy is reflected in its ability to attract foreign capital which seeks safety in an often uncertain world.

Unnecessary controls would be viewed by foreign interests as politically capricious. They would weaken the perceptions that the United States is a good place to invest, therefore undermining our ability to attract foreign investment. Controls also would weaken our ability to persuade other nations to remove barriers they impose to the free flow of capital.

I would now like to comment on what is perhaps the most serious weakness of the controls proposed in this legislation -- the fact that they would be totally ineffective. I have already mentioned that our allies would not support such controls. Therefore we must look to our own market share to determine the potential effect that controls imposed unilaterally by the United States would have.

In this case the U.S. banks have a very small share of the total market. Measured in terms of total "exposure" to Bloc nations, U.S. banks' share is between 6% and 7%. Exposure takes into account commitments to lend as well as outstanding claims and incorporates only assets for which banks are at risk. U.S. banks' exposure, which declined to $2.6 billion in June, compares to the exposure of non-U.S. banks of roughly $40 billion.

At times the syndications led by U.S. banks are reported as lending by U.S. banks, when in fact the end participation of U.S. banks as lenders has been very small. While there has been a modest resumption of lending by U.S. banks to some Bloc nations, on balance outstanding loans of U.S. banks have continued to decline.

It is worth noting that net lending (new loans less repayments) in the first half of this year was by non-U.S. banks.

Net lending to the Bloc was on the order of $3 billion, and all was provided by non-U.S. banks. The outstanding claims of non-U.S. banks increased to a level of $49.3 billion. (The claims of non-U.S. banks are larger than their exposure, because their exposure excludes, but total claims include, loans guaranteed by other institutions, particularly official export credit agencies.)

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You asked about administrative aspects of the bill. Should the bill be enacted, Treasury's Office of Foreign Assets Control (OFAC) would be responsible for administration of any controls imposed. OFAC presently administers economic sanctions measures, authorized by the Trading With the Enemy Act and the IEEPA, against South Africa, Nicaragua, Cuba, Viet Nam, North Korea and Cambodia. Exactly what might be needed in terms of additional personnel would obviously depend on the contours of any specific controls imposed and cannot be predicted on the basis of the language of the bill itself.

Conclusion

The Presidential meeting in Geneva was an initial step toward more stable and constructive East-West relations. One element of such a relationship must be mutually beneficial non-strategic trade. Although the authority contained in S. 812 is discretionary, it would have a chilling effect on the President's efforts to encourage mutually beneficial nonstrategic trade, but without producing any concomitant benefits to our efforts to control the flow of strategic technology to Soviet Bloc countries. The message this legislation would send runs directly counter to the message from Geneva and would create confusion among our allies concerning our policy towards the Soviet Union.

The Administration strongly opposes new authority to monitor and impose controls against the Bloc, and possibly other countries, because in our view such action would not achieve the strategic results intended. However, it would damage U.S. financial and economic interests as well as relations with our allies, who will resist attempts to persuade them to cooperate. It would be a perverse effect if in an attempt to injure the Bloc we instead weakened the Western Alliance.

Senator **Garn**. Mr. Mulford, most of your testimony is not new. I have heard it several times through different administrations. I guess I had hoped I would hear something new and different other than "it won't work, and we shouldn't do it, and it might harm our image or whatever."

I don't know that I have ever heard such overkill for such a minor bill, as your last statement:

> However, it would damage U.S. financial and economic interests as well as relations with our allies who will resist attempts to persuade them to cooperate. It would be a perverse effect if in an attempt to injure the Eastern bloc we instead weakened the Western Alliance.

HEAVY HAMMER USED ON S. 812

My goodness. My little old bill is going to weaken the whole Western alliance and cause perverse effects. I am sorry. It is not you personally, but that is the hugest hammer I have ever seen to try and stamp out a minor little bill that gives discretionary authority to the President, which if he doesn't like—I used to be mayor of a relatively small city compared to the whole United States, and my council gave me authority sometimes that I didn't like, and I said, fine. I think you are stupid, and I don't intend to use it.

And here we are stomping this with a great, big C-5A or something, perverse effects. I just can't believe the overkill of your statement. It must be a better bill than I thought it was if it is going to have all those kinds of consequences.

Why are you so opposed to discretionary authority? We are not trying to mandate the President to do anything. We are trying to give him some authority that may or may not be useful, and in some cases the intended results that you are talking about would be absolutely true, and I would undoubtedly agree the President should not use the authority in a particular case. But some nonemergency things come up again that we attempted to use controls on before, whether used well or not.

Why such a fear of a discretionary bill?

Mr. **Mulford**. Well, first of all, I think as was stated before in the testimony, it sends a chilling message, the wrong message at the wrong time. I think that is point one.

I think point two is that if you have adequate legislation for emergency situations, there is really no need to have additional legislation passed and put on the shelf which can be used on a discretionary basis.

The **Chairman**. Was the shooting down of the KAL a nonemergency situation? I would assume in terms of strategic balance and all of that, that it was. It wouldn't fit under IEEPA.

Mr. **Mulford**. Well, let me just continue the reasons to the first question you asked me. Second, if you have discretionary legislation and you argue that the President need not use it, you are getting a disadvantage out of the fact that it exists in the meantime and is there for possible use.

Third, once it has been passed and is on the shelf, when a political event takes place, there could very easily be a clamoring that it should be used, and at that point people will begin to say well, there are tools there, the legislation is there and why doesn't he use it, and the pressure would increase to use something which might be ill-considered.

And, finally, once passed it may survive the present President and in the future may be used without so much discretion by another President.

So I see no reason for us to have legislation which is in essence undesirable, available on a discretionary basis.

The CHAIRMAN. In other words, we are continuing the present policy of the U.S. Government regardless of who is President. We are really afraid to take any direct and stern action because we might offend someone.

We kid ourselves by going back into this period once again of détente and euphoria, the game is played over and over again. We will see another Afghanistan and we will see another KAL, and we are not supposed to say anything naughty because our allies will be offended. So pamper the giant.

Does this President or any other President have the courage to resist pressure? There is pressure that comes out of this body all the time for Presidents to do things. It happens every day. We are passing joint resolutions on the floor, and you get that pressure whether you have got discretionary authority or not.

I am just really puzzled by such overwhelming opposition to what is really a rather minor piece of legislation compared to what we might have tried to enact.

Mr. MULFORD. Well, I think there isn't very much deterrent effect on evil actions from legislation which when passed everybody knows is hopelessly ineffective in its result. So I don't see that there is any point in having available tools that are known from the start to be ineffective. I don't think that is a deterrent to evil actions.

The CHAIRMAN. Well, that is your opinion and demonstrates your unwillingness to try. That was the situation on the Yamal pipeline. We were unwilling to try until finally when it was too late, we did too little, and then everybody got accused of it being ineffective.

Mr. MULFORD. Well, I think that the gas pipeline episode, and I was not here at the time, but it clearly had, whatever the background was, an adverse effect on the Western alliance and relationships between Western allies were seriously and adversely affected. That is fact.

The CHAIRMAN. There is no doubt about it——

Mr. MULFORD. No doubt about it.

The CHAIRMAN [continuing]. Because we didn't take a firm stand to begin with and we didn't talk to them first. The pipeline was already being constructed and pipe was being put in the ground before we even decided what our position was. So, yes, at that point you are absolutely correct.

DISPARITY OF LOAN RATES

I don't know what State you are from, but I couldn't justify to the people of Utah why Western banks, and I really don't care whether the Western alliance in that case was irritated or not, because I couldn't go home and make a speech when the prime rate was 21 percent and mortgage loans for 30 years were as high as 17 percent and Western banks were making loans to the Soviet Union to build a pipeline at 7 and 9 percent interest. I really couldn't explain that at home, and I am pretty good at explaining things.

So, if we are going to make loans to the Soviet Union, at least we ought to have a national policy of some sort that they are market rates. I am not one who advocates cutting off trade with the Soviet bloc. I am not totally cutting it off. I am not one who advocates totally cutting off all loans. I don't want to back them into a corner either. I am not an advocate of that kind of stark treatment, but I have not been able to have explained to me by anyone yet, why in the world we treat them better than we treat ourselves.

During the Yamal pipeline debate we were also debating at that time the economic feasibility of building a natural gas pipeline through Canada to the United States from Alaska. And do you know what we were told? It was not economically feasible because interest rates were too high. That pipeline was not built.

Now when this administration or any other can explain that kind of treatment, that we make loans at half the market rate to nations that are such violators of human rights and a threat to the security of this country, but we can't build our own pipeline because it isn't economically feasible because the interest rates are too high.

Maybe you will understanding a little bit of my frustration when I hear the same type of testimony over and over again. No doubt about it, a lot of your criticisms are correct, but do we continue to just wave a white flag, and we do have to have better trade relationships with our enemies than we do with our allies. Our allies don't get the kind of loan rates that we give to the Soviet Union and the Soviet bloc countries.

I don't understand why we have to treat them better. If we are going to make them loans for the Yamal pipeline, say, fine, this is the going market rate. This is what it would cost us in the United States to borrow money to build a pipeline through Canada. If you want money at that interest rate, be our guest. We will loan it to you, but not at preferential rates.

Now I am going beyond what you are here for. You weren't here at the time and I was, and I am still burning from those types of decisions, but we continue to make them.

Mr. **Mulford**. Well, I don't think we should leave that impression though at this hearing this morning. I can't comment on what rates applied at the time the pipeline was being put together because I don't have that information. But clearly in the general flow of financial business that is being done by commercial organizations today in the markets, the Eastern bloc countries do not receive preferential terms. They receive market terms and indeed the terms are rather, in my opinion at least, rather adverse compared to those for many other countries of similar economic strength.

If you take a look at where their terms fall in the sort of ladder of terms running from prime credit countries to the developing countries that today have major debt problems, the Eastern bloc as a rule borrows on terms that are closer to those of the developing countries than they are to the prime credits.

It is clear that one of the reasons they are able to attract money in the market in recent months is that they have been willing to provide very rich terms and this has helped them sell their bank financing deals.

So, today in the present market the kind of banking deals that have been announced over the past 6 months or 1 year or so indicate that they clearly are paying at market terms and not particularly good market terms, in my opinion.

So I think we ought to correct the impression that somehow they are being given preferential treatment and lent money by our banks at half the market rate.

The **Chairman**. Well, we have had testimony from some bankers that the interest rates are so low that they are primarily interested in the fees.

Mr. **Mulford**. Well, it is true that fees might offset the level of interest rates to some modest extent. I can provide for you in writing the general ladder of terms that are enjoyed by different kinds of borrowers, and the Eastern bloc fits in relatively far down that ladder, and that is fact. I mean that is demonstrable.

It is true that up-front fees may be used in some circumstances to reduce rates, but that is a modest impact. It certainly doesn't have anything like the impact of dividing the cost of money in half or something like that. I mean it has a very modest impact.

IMPOSITION OF CONTROLS WOULD BE DAMAGING

I would also make another point in response to your question. I think that one of the reasons, and probably the most important reason that the administration opposes this bill, is that it would damage us to impose such controls.

It would have some, as I said in my testimony, negative impact on our trade relations and we are attempting to conduct a constructive trade relationship with the Eastern bloc.

But I can go back in time, because I have been in the financial business for many years, and point out a case where economic controls, financial controls in particular, were used on capital markets. This was in the midsixties. The result was that we created the Eurodollar market in London, which today has grown up to be a major market, major in importance, major in size, and a huge source of business to the world.

That market, because we had controls, was driven offshore, based in London and has been there ever since. When we removed the withholding tax—the last of our controls that mattered—this past year, that market didn't come home.

So there is a market which could have been an onshore, international market housed in the United States and benefiting our entire country, which was driven offshore by controls and which didn't come home, in my opinion, for one reason, and that is that world participants in that market fear capricious actions of this type by the United States in the financial area. This fear makes them take the view that we can't really be trusted as the home of a major international market because it is unclear what we are going to do next by way of legislation or controls or otherwise for political reasons.

That is why that market has stayed in the United Kingdom where, incidentally, in London in the last 300 years except during periods of hostilities there have never been controls put on the flow of capital as it relates to foreign participants in their market.

The CHAIRMAN. Let me ask you one more question then. Let me assume for argument's sake that all of your arguments on why it won't work and why it shouldn't be done and the lack of trust and all of that are correct. Then, why was the President willing to impose capital controls on South Africa, and why don't your arguments against controls apply to South Africa as well? I am sure he wouldn't have considered using IEEPA authority in declaring a national emergency to impose those types of capital controls.

Mr. MULFORD. The administration opposed economic sanctions for South Africa as counterproductive and, in the end, agreed to a package of controls which were designed to provide a signal to South Africa, but not designed to make a 100-percent cutoff, for example, of credit to South Africa. There were limitations on that.

The intention of the administration was to send a message without laying out a body of controls that would produce a long-term negative impact on South Africa's economic well-being.

The CHAIRMAN. Under what authority did he do that?

Mr. MULFORD. But the point here is that it was not what this bill would produce, basically a shift in our stance from constructive trade relations to, basically, economic warfare.

In the case of South Africa, the shift was not complete to that point of 100 percent economic warfare against South Africa.

The CHAIRMAN. Did the President use IEEPA?

Mr. MULFORD. Well, there was specific legislation passed.

The CHAIRMAN. Well, there was specific legislation passed by the Congress. But did we use IEEPA?

Mr. MULFORD. Yes, it was used. Yes, we did.

The CHAIRMAN. Was there a national emergency?

Mr. MULFORD. I mean, that is a matter of opinion but I would myself say, no.

The CHAIRMAN. Well, then, how did the President use IEEPA?

Mr. MULFORD. Well, I think that is a legal question that should be addressed to general counsel.

The CHAIRMAN. It sure is, and that is what I am talking about. You have adequately demonstrated that there is a gap in the President's authority. I think it could be very easily argued that using IEEPA, that you could not declare a national emergency in that situation. That is what my legislation is designed to do, to give the President discretion.

If this legislation had been passed, he would have fully had the discretion to do exactly what he did with South Africa. I would suggest IEEPA was not followed legally, and I am not, certainly, going to push that. I am not an attorney. But I know a little bit about IEEPA and the Trade Act after having worked on it most of my adult life—at least it seems like that.

You are supposed to declare a national emergency. There was no national emergency. The President did not declare one. It might have made some sense to have some authority when we find selective cases which we can then rationalize and justify why controls were all right in this case but totally ineffective in others—for whatever reasons—and have the authority for this President or future Presidents to do that.

I have gone 5 minutes over my time. Senator Proxmire.

Senator PROXMIRE. Mr. Mulford, I understand that you are representing the administration when you state your opposition to the enactment of S. 812.

CABINET DEEPLY DIVIDED

The New York Times carried an article on December 3, yesterday, noting that the Cabinet was deeply divided on whether to support S. 812. The article noted the Secretary of Defense, the Attorney General, the National Security Adviser, and the Director of the Central Intelligence Agency all supported the enactment of S. 812, while State, Commerce, and Treasury opposed it.

Is that true?

Mr. MULFORD. At the meeting that I referred to in my testimony yesterday where I was present myself, there was debate of this issue and a decision was taken by the President to oppose the legislation.

Senator PROXMIRE. Well, is it true that the Secretary of Defense, the Attorney General, the National Security Adviser and the Director of the CIA all favored it?

Mr. MULFORD. Well, I do not think I should comment on the contents of a newspaper article as to who said what to whom. But there was some discussion and, obviously, this is the sort of issue which does stir up different opinions. People have different views on this subject and there was discussion.

Senator PROXMIRE. Well, I am not sure how much I can elicit from you on this, but let me try.

I had understood that a witness from the Defense Department would be here today. Since he is not, could you tell us the reasons that the Department of Defense and the CIA favored enactment of this bill and why they were overruled by the administration?

Mr. MULFORD. I do not think I should speak on their behalf, especially when an administration decision has now been taken.

Senator PROXMIRE. Did the President himself actually take part, was he physically present in the room?

Mr. MULFORD. Yes, he was.

Senator PROXMIRE. He was.

Mr. MULFORD. Yes.

Senator PROXMIRE. And he expressed the final decision himself?

Mr. MULFORD. Yes, he did.

Senator PROXMIRE. I have a copy of a letter dated August 27, 1985, sent by the Department of Defense to the Office of Management and Budget. At the time, the latter office was trying to pull together an administration position on S. 812.

The letter states:

> As you know, the Department of Defense favors S. 812. The Department of the Treasury, however, opposes enactment of the proposed legislation. The Department of Defense strongly disagrees with Treasury's conclusion for the reasons that follow.

DOD then spelled out why it wanted the President to have the authority to regulate bank loans to the Soviet bloc. The letter noted that East Germany recently took a $500 million loan from American banks and then promptly, "granted a new cash loan of

$20 million to Nicaragua, untied to any project and therefore available for weapons."

The letter from DOD further stated that:

> Restricting loans to Soviet bloc nations would limit the amount of hard currency available to those nations to finance their foreign adventures and purchases, both legal and illegal, of Western technology.

The letter continued: "Even a small reduction in the level of hard currency available to the Soviets would require the Soviet bloc to make more difficult choices between competing demands."

These arguments certainly make sense to me. Can you tell me why, despite them, Treasury urged the President to reject the discretionary authority provided him in S. 812 to regulate bank loans to the Soviet bloc?

Before you answer, let me ask the chairman to have the August 27, 1985, letter from DOD put in the record.

The Chairman. Without objection, so ordered.

GENERAL COUNSEL OF THE DEPARTMENT OF DEFENSE
WASHINGTON, D.C. 20301

27 AUG 1985

Mr. Joseph R. Wright
Acting Director, Office of
Management and Budget
Washington, D.C. 20503

Dear Mr. Wright:

This responds to your request for the views of the Department of Defense on the draft report of the Department of the Treasury on S. 812, 99th Congress, a bill, "To amend the Export Administration Act of 1979 to authorize controls on the export of capital from the United States."

As you know, the Department of Defense favors S. 812. The Department of the Treasury, however, opposes enactment of the proposed legislation. Treasury has expressed the belief that the restriction of commercial capital flows is unwarranted, unmanageable, and would reduce the attractiveness of United States financial markets. The Department of Defense strongly disagrees with Treasury's conclusions for the reasons that follow.

S. 812, sponsored by Senators Garn and Proxmire, was introduced on March 28, 1985, partly in response to recent very large loans by United States banks to the German Democratic Republic (GDR). Given the heavy debt burden of East European countries, the overextended loan exposure of West European bankers in Eastern Europe, and only a moderate improvement in regional economic conditions or prospects for higher export earnings which might be applied to debt service, both West European and United States banks had been expected to exercise considerable restraint in new lending to the Soviet Bloc. When the GDR investigated the possibility of a $100 million loan, however, United States banks unexpectedly offered $500 million. The GDR rapidly accepted the higher amount. New loans of this size have serious political/economic implications. The amount of the loan was large enough to assist in financing Warsaw Pact support of Soviet adventures and operations in the Caribbean and Central America, as well as other regions, while sustaining imports of strategic technology. For example, the GDR granted a new cash loan of $20 million to Nicaragua, untied to any project and therefore available for weapons. In addition, the GDR $500 million loan might set a precedent and be repeated at a time when restraint in lending in Eastern European countries by both West European and United States banks is needed. Therefore, S. 812 is also important as a means of educating the public and influencing private bankers in the direction of greater restraint, through public discussion and Congressional hearings on these important and complex political/economic issues related to national security.

The Department of Defense takes issue with Treasury's assertion that passage of S. 812 is unwarranted. Treasury states that similar powers are granted to the President under the International Emergency Economic Powers Act (IEEPA), which would require the President to declare a national emergency. The Department of Defense's position is that it is unwise to address the existing problems only after they have developed into an emergency situation. The current situation is serious enough for the United States to take action. Recent studies have shown that the Soviet Bloc purchases of technology are currently costing the United States billions of dollars. S. 812 is warranted in that restricting loans to Soviet Bloc nations would limit the amount of hard currency available to those nations to finance their foreign adventures and purchases (both legal and illegal) of western technology. Even a small reduction in the level of hard currency available to the Soviets will require the Soviet Bloc to make more difficult choices between competing demands. Forcing the Soviet Bloc to make these choices is preferable to providing them with additional means of financing their full range of operations, projects and purchases in the free world without increased sacrifices in other areas.

Treasury's belief that financial export controls would be unmanageable is based on the difficulty of unilaterally controlling the flow of credit to certain countries. The Department of Defense agrees that consensus with our western European allies on financing export controls would be desirable. In lieu of allied cooperation, however, strong United States action would still produce positive results. United States banks have recently been offering loans to the Soviet Bloc at interest rates well below the rates offered by European banks, thus making it less expensive for the Soviet Bloc to borrow. In addition, by borrowing from United States banks, countries such as East Germany can avoid making concessions on issues such as immigration and human rights which are often a part of west European loan agreements with the east. Thus the renewed United States lending to the Soviet Bloc has reduced both the political and economic costs of borrowing for the Soviet Bloc. S. 812 would restrict the ability of United States banks to bid down the cost of borrowing for the Soviet Bloc.

The Department of the Treasury also expressed concern that S. 812 will reduce the attractiveness of United States financial markets as an outlet for foreign financial investment. Treasury's concern is based upon the fear that foreign investors will read S. 812 to say that the United States will impose financial sanctions against any country with which the United States has policy differences. It is highly unlikely that this misinterpretation would occur. The President would not be able to apply financial export controls against just any country. S. 812 states clearly that the financial export controls could apply only to countries for whom we already have technology export controls for national security reasons (i.e. the Soviet Bloc). These controls would not, however, be mandatory. The President would be able to differentiate between the affected Soviet Bloc countries and could allow unrestricted loans in response to positive trends in specific countries.

The Department of Defense agrees with the Department of the Treasury that extraterritoriality and the intended limits of the proposed legislation should be addressed by the committee in their deliberations. The bill itself should then be amended in order to state clearly the committee's intentions on this issue. Treasury also states that the United States should continue its efforts to tighten COCOM rules and enforcement. There is no doubt that the United States must in fact continue this effort. It should not, however, be our only effort. The problem of technology transfer is a pressing threat to our national security which creates the additional problem of requiring ever higher defense expenditures in order to maintain our technological edge.

The United States must therefore take the lead on this issue. We do not expect that all of our allies will follow our lead. We do expect, however, that American action will demonstrate to the world banking community the importance the United States places upon this issue. In addition, passing S. 812 will have a concrete effect on the ability of the Soviet Bloc to finance foreign operations and purchases with hard currency. For these reasons, the Department of Defense expresses support for S. 812 and is unable to concur with the proposed report of the Department of the Treasury to Congress.

Sincerely,

Chapman B. Cox

Senator PROXMIRE. Go right ahead, Mr. Mulford.

Mr. MULFORD. In order for me to answer it clearly, if I do not pick up all the points you made, please give them to me again.

MONEY IS FUNGIBLE

But as I recall them as you went through them, the answer to the first one is the fact that money is fungible. It is perfectly obvious that if hard currency is lent to these countries for general trade purposes, it is not impossible that some of that money might be used for military or other exercises because money is fungible and you cannot ensure that every penny lent for general trade purposes will end up being used as required or as intended.

But that does not change the basic thrust of our argument that this piece of legislation is too blunt a tool to try to control that.

Senator PROXMIRE. Mr. Secretary, let me interrupt just for a minute because this might help you clarify your position that the fungible argument is the answer.

The letter noted that East Germany recently took a $500 million loan from American banks and then promptly granted a new cash loan of $20 million to Nicaragua, untied to any project and therefore available for weapons.

Now, I think from what you say, they could have made that $20 million loan anyway. It certainly would have been harder if they had not been able to get the half billion dollars in credit from American banks; is that correct?

Mr. MULFORD. Well, they may well have made the $20 million loan anyway. That is the first point.

Senator PROXMIRE. That is a possibility.

Mr. MULFORD. The second point is that if American banks had been forced to withdraw from that loan, it is not a fair conclusion that there would have been a reduction in hard currency flowing to that country because, as I have already indicated, in these loans which are attractively priced, other banks would be just as happy to pick up our share of the loan and lend the money anyway.

So, you do not produce a reduction in hard currency flows. And the money is fungible argument applies to both of those points. Just because our banks—which, as I have said, have about a 6- to 7-percent exposure to the Eastern bloc in general—withdraw, that is a very small shortfall to be made up by other eager banks of other countries who find the terms attractive and, no doubt, would step in and pick up that lending.

So there would have been no reduction in the size of that loan.

Senator PROXMIRE. You say there would be no reduction. You do not know whether there would or not, whether they could get the loans from other countries. That may be the case or may not be the case. Whether they get them on the same terms is something else.

In addition to that, there is the fact that American money is being used to fund a government in Nicaragua against which we are very much opposed.

I have been critical of our position on Nicaragua. But it seems to me it does not make any sense at all for American money to fund Ortega's operation while we are at the same time putting money into the so-called freedom fighters.

Mr. **Mulford**. Well, I think I can say with absolute certainty that that loan would have been the same size. There would have been no problem in reaching that size. That loan was increased in size, as I remember, from something like $100 million or $150 million to $500 million. Because the demand was so great from banks around the world to take part in that loan, the size of the deal was increased by an enormous amount.

So I think it is neither here nor there whether, if U.S. banks had not been in it, it would have still been a $500 million loan since it was increased from $100 or $150 million to $500 million in the first place.

So I think I can be absolutely certain on that point. I can be less certain, of course, about whether if there had been no loan whatsoever, they would have still found $20 million to lend to Nicaragua; I have no idea whether they would have or not.

EFFECTS OF LOSS OF WESTERN CREDITS

Senator **Proxmire**. Mr. Mulford, in response to a question I asked the State Department in 1982 when we had our hearings on the Polish debt crisis, the State Department said:

> If the Soviet hard currency position were further harmed by a loss of Western credits, the leadership would be likely to adopt domestic economic policies restricting private consumption in order to allow for continued growth in defense spending. While Western credits may not directly strengthen the Soviet military, they do make economic decisionmaking easier for the Soviet leaders.

Do you agree with that analysis by the Department of State and, if not, explain the basis for your disagreeing.

Mr. **Mulford**. Obviously, access to capital markets is very important for any country, and if foreign sources of capital are not available to a country which does not itself have a developed capital market to produce its own resources—such as we have, for example—then it is true that cutting off the supply of capital to that country might limit substantially their options.

Our problem with this legislation and with the world as we find it today is that it would not produce that result. It would be ineffective because it would be a unilateral action by the United States which would not have the effect of cutting off capital to the Soviet Union or any other Eastern bloc country.

Now, if there was a way to shut down all hard currency flows to these countries, if that could be effectively accomplished by all the Western countries together, then you would be talking about a situation in which the effect would be different.

But that is not what we are looking at today.

Senator **Proxmire**. Does not this give the President power to negotiate, work with other Western bloc countries?

Mr. **Mulford**. I do not think so.

Senator **Proxmire**. So that we can coordinate our national relationship to the Soviet Union in a way that will not advance their aggressive actions?

Mr. **Mulford**. I do not believe it would work that way. I think there is as much to be said for the fact that it would damage our relationships because, for example, we would find countries which have branches of U.S. banks and this piece of legislation hanging over them, taking the view in any such conversations, "You know, this legislation you have does not apply to the branches of American banks in London or Frankfurt, or whatever," and we would say, "Yes, it does." They would say, "No, it does not. Would you like to test it in our courts?"

We would be back where we were in the case of the gas pipeline or even Iran which was a situation which is still having some fallout in financial markets, where there were legal battles over this question of extraterritoriality.

This is a very, very sensitive issue. I do not think it is constructive to pass legislation which puts that issue out in the foreground.

Senator **Proxmire**. Well, the trouble, Mr. Secretary, is that you and I are discussing this in generalities. There are times and situations where it would seem to me it might be possible to persuade our allies to work with us if the President had this power. In such cases with this legislation, we would be in a position to act and act promptly.

You are absolutely right in pointing out that there are many situations, in which the President would not be able to persuade our allies. In such cases it might be counterproductive to act. But this bill gives him a discretionary capability which he does not have. It seems to me it could strengthen his ability to restrain Russian aggression which might be based on their economic capability.

My time is up, Mr. Chairman.

The **Chairman**. Senator Sasser.

Senator **Sasser**. Thank you, Mr. Chairman.

Good morning, Mr. Secretary. I hope you are enjoying your morning.

Mr. **Mulford**. Yes, I am. Thank you.

Senator **Sasser**. Mr. Chairman, I certainly have no argument with the intent of S. 812. It is designed to limit the access of controlled countries to the resources for acquiring sensitive technology or equipment on the black market.

That intent is in line, I think, with the national defense interest of the United States. It is in line with the intent of the Export Administration Act.

But as you have said, Mr. Secretary, the resources we are talking about are dollars; and money, by its very nature, is a fungible asset. As you know and as I know, the world financial system is interlocking and funds are transferred in a matter of seconds.

DIFFICULT TO CONTROL FLOW OF FUNDS

I am concerned, as some of our witnesses have been, about how dollar controls could be enforced. How can the bill's objective be achieved if not by loan controls? Or is there no way to achieve the bill's objective without doing ourselves more damage than we do the Eastern bloc?

I suppose that is the basic, fundamental question.

Mr. **Mulford**. I agree with your reasoning on that, that there is no effective way in the case of financial controls to really produce the effect that you want and with which in some cases with which the administration might be in sympathy.

But there is no point in having legislation which must be ineffective when it is put into use and which, incidentally, as you pointed out, might very well damage us more than it does them.

I tried to give an example earlier of the Euromarket which has now been in existence for 25 years. That is a major loss to our economy. Likewise, if this kind of measure were taken, I think we would see some negative effect on trade flows. It would be harder for the U.S. exporter exporting perfectly ordinary goods to these countries to finance his trade. The result would be damage for our economy.

Senator **Sasser**. I assume then, Mr. Secretary, that is the reason this administration and previous administrations have taken the same view on this legislation or similar legislation.

Let me talk for a moment about the Soviet Union. You alluded earlier to Geneva, our relations with the Soviet Union and our security interests.

The Soviet Union is the world's No. 1 oil producer. But I noted in yesterday's New York Times that Soviet oil production has dropped from 12.3 million barrels a day to 11.8. This is, of course, partly due to a drop in world oil prices, and partly due to severe production difficulties in some of the Western Siberian oil fields.

These difficulties have caused Soviet foreign exchange earnings to plummet. As I understand it, the only thing they have to sell is either oil or gold. Nobody else wants much of anything else they produce.

Their foreign exchange earnings have fallen from $5 billion to $2 billion. The Soviets for the first time during the 1980's are facing a deficit of hard currency transactions.

What are your views, Mr. Secretary, of the implications of this state of affairs? What would be the benefits and what would be the risk, if any, to the United States of a Soviet foreign currency deficit?

Mr. **Mulford**. Well, the Soviet Union when it develops a foreign currency deficit as it is doing at the moment, has the option—because it is an outstanding credit—to turn to foreign markets to borrow hard currency, which is what it is now doing. It would borrow on relatively good terms.

I have made the point before that when it decides to turn to foreign markets, there will be a market there in the international arena in which we are a very modest participant.

It seems to me that if the Soviet Union, for the reasons which you cited, turns to the market and the United States decides unilaterally that its banks cannot participate, it is not going to make any difference whatsoever to the Soviet Unions ability to attract sufficient hard currency to meet its needs.

That is the basis of my point when I say that it would be ineffective because it would not have, if it were a unilateral action on our part, the desired effect. We see no prospect that our allies would support such an exercise.

Senator **Sasser**. So if we cut off the funds to the Soviet Union, they might just decide that they will borrow the money from Canada and buy Canadian wheat as opposed to United States wheat.

Mr. MULFORD. Well, in doing a syndicated financing without the Americans, the group would just be there without the Americans and everybody else would pick up a bigger piece. It would be shared around by everybody. And quite right you are to say, that if we made a unilateral action of that kind, the Soviet Union might very well decide to use its hard currency for trade purposes with countries that were regarded as friendly, constructive, and not taking unilateral actions against them.

I think our trade would suffer as a result.

Senator SASSER. So I gather it is your testimony today, Mr. Secretary, that you agree with the end goal of this legislation, but you simply do not think that the goals can be implemented without doing ourselves more damage than we do the Eastern bloc.

Mr. MULFORD. I think there is a certain sympathy for some of the ends of the legislation. I believe it is not in the general interest of the United States to use capital market controls in a capricious way that is adverse to our interests.

Senator SASSER. Thank you, Mr. Secretary.

The CHAIRMAN. Mr. Mulford, let me return just one moment to the issue of IEEPA and national emergency. The President did declare a national emergency in order to use IEEPA. I would certainly agree with your personal assessment that there was no national emergency.

There might have been, however because I see his declaration of a national emergency was because Congress was about to pass a law and that very well might be a national emergency, considering some of the things that we create around here. [Laughter.]

But I think it illustrates my point that this type of legislation would have allowed the President discretion to do what he did, without really bending IEEPA to declare a national emergency. Nobody would seriously agree that there was a national emergency or a threat to the security of this country as a result of what was going on.

HELPFUL TO HAVE DISCRETIONARY AUTHORITY

Now, I have to go back to the point that it is discretionary. It might be helpful in many situations for a President to have that discretionary authority. Many of the things that you point out under this discretion, you would have to have a real incompetent as President for them to occur.

Senator Proxmire is absolutely right, there are undoubtedly far more situations where a President—this one or any other—would not want to use that authority than there would be where he would find it necessary or useful to use.

That is why we have such a very distinct difference of opinion, for it is discretionary. I still happen to think it would be very, very helpful.

Senator Proxmire.

Senator PROXMIRE. No, thank you, Mr. Chairman. I will wait for the next witnesses.

The CHAIRMAN. Mr. Secretary, we will have some additional questions for your response in writing. But we appreciate your willingness to go through this onslaught this morning.

Mr. MULFORD. Thank you very much, indeed, for having me.

The CHAIRMAN. Next, if we could invite a panel of distinguished witnesses to the table. Mr. Barry Carter from Georgetown University Law Center, Dr. Richard Pipes from Harvard University, Mr. Henry Schechter, Deputy Director, Economic Research Department of the AFL-CIO.

STATEMENT OF BARRY R. CARTER, GEORGETOWN UNIVERSITY LAW CENTER

Mr. CARTER. Thank you, Mr. Chairman and members of the committee. My name is Barry Carter and I am an associate professor of law at Georgetown University Law Center.

I want to thank you for your invitation to testify here today on the bill.

I support the general thrust of Senate bill 812—that is, to give the President the authority to impose controls over exports of private capital.

At the same time, I have some concerns about the bill in its present form and some recommendations for improvement.

My comments today draw on an extensive study that I am now completing on U.S. laws for international economic sanctions for either national security or foreign policy purposes.

PRESENT U.S. LAWS FOR SANCTIONS ARE HAPHAZARD

Before specifically addressing S. 812, I would like to place that bill in the context of the study. In the absence of a declared national emergency, as the chairman has pointed out, the present U.S. laws for economic sanctions are at best haphazard.

This can strongly influence the President's choice of sanctions and not necessarily in a way that is most in the U.S. national interest. Let me explain briefly.

There is a wide variety of U.S. laws today. I think we can break them down best into five categories of control on:

First, U.S. Government programs such as foreign assistance; second, exports; third, imports to the United States; fourth, private credit; fifth, international financial institutions.

For our purposes today, I think the most useful comparisons are between export laws, import laws, and laws regarding private credit.

The legal regime here is haphazard, it is uneven. If the President wants to impose economic sanctions, existing U.S. laws today encourage him to resort to export controls where he has relatively unfettered legal powers. This committee has been involved in rewriting the Export Act and they put some limitations on the President's power in 1985. But he still basically has unfettered legal powers to cut off exports.

At the same time, he has very limited powers to cut off imports for national security or foreign policy reasons. The import laws that exist are primarily for economic reasons, and not for foreign policy or national security reasons. And when we come to bank lending, as we will see in a second, he has very limited power.

In certain cases, however, import sanctions or limits on private credit might be more effective and might cause less harm to domestic industry and workers than cutting off U.S. exports. Indeed, using export controls, as we do so quickly today, can often be the legal version of shooting oneself in the foot.

If the President does not want to have his choice of sanctions skewed toward export laws, he can declare a national emergency. That gives him sweeping power over exports, imports, and private credit. But the purpose of the statute that gives the President these powers—the International Emergency Economic Powers Act [IEEPA] was to reduce resorting to dubious national emergencies.

Mr. Mulford was a little unsure whether or not there was a national emergency. The President had to find one to impose all the sanctions he did against Nicaragua or south Africa.

The criteria for invoking IEEPA are vague. What is a national emergency? Moreover, the Presidential powers are sweeping and Congress has very little to say. We should not be comfortable with casual resort to declarations of national emergency. Yet, that is what we did twice last summer—first for Nicaragua and then for South Africa.

But we also should not be comfortable with the crazy quilt of laws for declaring economic sanctions in the absence of a national emergency.

LIMITED POWER OVER PRIVATE CAPITAL

Let us look in particular today at the private credit area. Just as the President's power over imports is very limited, so too is it very, very limited over private credit today. If Chase Manhattan Bank wants to make a loan to Poland, or to Iraq, or to Chile, the President has very little statutory power in a nonemergency situation to prevent that loan. Essentially, Chase Manhattan or First National City Bank can do what they please.

The President's primary statutory authority over private capital is section 15 of the Export Administration Act. However, its language and legislative history suggest that it is only designed to limit export financing. Section 15 does not appear to be an independent source for limiting financial transactions. And I do not hear anyone today claiming that it is.

Well, what about informal pressures by the President on the banks? While banks are extensively regulated, it does not appear that informal pressures work very effectively. A recent, excellent study by a banker indicated that because of the arm's-length relationship in the past between banks and the United States Government on foreign policy matters, if the President went to them and said, "Please, do not loan to Poland, or to Iraq, or to Chile," he might just get a cold bath. They might not agree with him.

Moreover, I think it is a little strange that this country would rely on informal pressure when there might be situations with urgent time demand, where a lot of banks and financial transactions are involved. What we need is some statutory authority.

What we need is a better legal system for imposing economic sanctions in nonemergency situations, so that the President is able to choose the most effective sanction and to choose it wisely rather than being forced to resort, say, to export controls.

That brings me to Senate bill 812. As noted earlier, I support the general thrust of the bill. However, I do have three major concerns about it.

First, why should the bill be limited to restrictions on capital to controlled or Communist countries only? Economic sanctions have been and will be imposed for a variety of national security and foreign policy reasons against a number of countries—Communist and non-Communist.

The President should have a full menu of options for possible use against countries supporting terrorists, such as Iraq or abusing human rights, such as Chile, as well as against Communist countries.

Indeed, capital controls are likely to provide maximum potential leverage where U.S. banks, traders, and other entities have traditionally extended much credit to the other country, where we are there in a big way.

Traditionally, United States entities have not provided much of the total Western credit to the Soviet Union or Eastern Europe. Mr. Mulford estimated that U.S. banks provide only 6 to 7 percent.

In contrast, U.S. banks, traders, and other entities have provided large amounts of credit to a number of countries in Latin America and Asia which could conceivably be a target of U.S. foreign policy controls at some time in the future. These include, for example, Chile and South Korea. Of total bank claims against these countries, United States banks at the end of 1984 provided about 51 percent of the loans to Chile and 31 percent to South Korea.

Let me suggest that the President should have the authority to control most exports of capital, just as today he has the authority to control most exports of goods and technology—not just to Communist countries but to other countries as well.

As for my second question, while I would expand the scope of S. 812——

The CHAIRMAN. Mr. Carter, can I just stop you at that point and say, I totally agree with you. It ought to be much broader and extend as you have suggested. But you have heard the nature of the opposition to even Communist countries, and the difficulty of getting the administration to favor the bill.

BROADENING THE BILL WOULD KILL IT

If you expand it as you and I think it should be, you put the last nail in any chance of its passing. If people have objections to Communist countries, you can imagine where it starts to flow when you add the others. But you are absolutely right, the bill should be broader than it is.

Mr. CARTER. Fine. Thank you, Senator.

Let me take you to where I believe the bill should be a little narrower. I expect that you and Senator Proxmire introduced the bill intending to authorize the President to impose credit controls for truly important cases of national security or foreign policy.

As I now read the bill, it does not limit the President's authority to control capital with the same relatively detailed restrictions as, say, there are for imposing controls on exports of goods or technology for national security or foreign policy reasons. For instance, in the Export Administration Act, for foreign policy reasons, there are provisions regarding foreign availability and provisions for consulting with our allies and with U.S. business. There are a number of provisions which you tightened up this summer in the 1985 amendments.

S. 812 now would put the credit controls after section 8 of the Export Act. It would not have the same criteria for imposing foreign policy or national security controls. It would not have the same consultation requirements, and the like.

I understand that you want to keep the target narrow now and just aim at one set of countries, the Communist countries. However, I suggest that you should develop the careful sort of restrictions that this committee wisely required for foreign policy and national security export controls on goods and technology.

The CHAIRMAN. Well, I would just say to you that whenever you introduce a bill, the purpose of holding the hearings is to gather information and suggestions. And the end result of the Export Administration Act, if you want to look at the changes and the permutations that went through from initial introduction to what finally became law, you would not recognize many of the provisions.

That is why, as I read Mr. Schechter's testimony, that he agrees with the thrust of the bill, I would hope that there would be suggestions for how we might improve it. We all agree on what we are trying to accomplish. The purpose is to attempt to find some way to accomplish that in the best possible manner.

Mr. CARTER. I think the committee is aware of ways to put in restrictions, from its earlier work on the Export Act, and some of those restrictions could be applied to the credit area.

For example, even for Communist countries, you might want to distinguish between capital exports for sales of high technology and the like and capital exports for grain sales. I believe in most cases we do not want to oppose grain sales to Communist countries. It helps our farmers. The real goal of the bill is to shut down exports of high technology and the like to Communist countries.

A third point, as the Senator suggested, you are still studying the problem. I hope that this committee will continue to study the possible effectiveness and enforcement problems of various types of capital controls, for Communist countries and otherwise.

As Mr. Mulford pointed out, money is very fungible. In a matter of minutes, hundreds of millions of dollars can be moved from one bank to another bank, to another bank. There are questions of effectiveness and enforceability.

I do not think that should stop this committee from going forward. But I do not think that enough analysis has been done, even for the South African capital controls. I support the sanctions on South Africa, but I have looked at the record and I do not think anyone has carefully analyzed how they are going to enforce these controls, how those controls on loans to the South African Government are going to be effective.

Some of the difficult analysis has not been done. I would hope this committee, so interested in the problem, can continue the work.

In one area, for instance, there might be a useful distinction. We might fairly easily be able to enforce controls on loans for specific trade deals. Usually the importer or the exporter uses the banks of the importing or exporting country for, say, a letter of credit. Such trade credit is usually fairly traceable.

But the tough question is, say, a loan of $500 million to Poland for balance-of-payment problems. Assume Chase Manhattan is told they cannot do it. Well, what happens then if Chase, in good-faith, loans $500 million to a Swiss bank? The next day, the Swiss bank loans $500 million to Poland at a slightly higher interest rate. The Swiss make a profit, and the Poles get the needed money.

That is what might happen in nontrade related loans. Maybe ways can be devised to work around this to make controls more effective. I am just not sure the hard homework has been done.

Well, again, in spite of my questions, I want to commend Senators Garn and Proxmire, and the cosponsors, for beginning the legislative effort to provide the President with some authority to limit exports of capital. As my comments suggest, however, I think there is some difficult research and analysis that should be done, and I think there is some rewriting that also should be done.

I would be happy to help you with that, and I thank you very much for inviting me here today.

[The complete prepared statement and response to written questions of Senators Garn and Mattingly follow:]

STATEMENT OF BARRY E. CARTER
BEFORE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
DECEMBER 4, 1985

Mr. Chairman and Members of the Committee:

My name is Barry E. Carter. I am an associate professor of law at Georgetown University Law Center.[1] Thank you for your invitation to present my views on Senate Bill 812, the proposed Financial Export Control Act.

I support the general thrust of S. 812--that is, to give the President the authority to impose controls over capital exports, or private credit. At the same time, I have some concerns about the bill in its present form, and some recommendations for improvement.

My comments today draw on an extensive study that I am now completing on the U.S. laws for imposing international economic sanctions for national security and foreign policy reasons. Before specifically addressing S. 812, I will place it in the context of this study.

In the absence of a declared national emergency, present U.S. laws for economic sanctions are at best haphazard. This can strongly influence the President's choice of sanctions, and not necessarily in a way that is most in the U.S. national interests.

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[1] In the past, Mr. Carter served on Dr. Henry Kissinger's National Security Council staff from 1970-72 and was a senior foreign policy advisor on the Mondale/Ferraro campaign staff in 1984.

Let me explain briefly. There is a wide variety of U.S. laws today for imposing these sanctions. These can be divided into five categories, possible controls on: (1) U.S. government programs, such as foreign assistance, landing rights, loan guaranties; (2) exports from the United States; (3) imports to the United States; (4) private credit; and (5) international financial institutions. For our purposes today, the most useful comparisons are with the three middle categories--exports, imports and private credit.

The legal regime here is haphazard, or uneven. If the President wants to impose economic sanctions, existing U.S. laws encourage him to resort to export controls where he has relatively unfettered legal powers, rather than to impose import controls or to try to limit U.S. bank lending. Yet, in certain cases, import sanctions or limits on private credit might be more effective and cause less harm to domestic industry and workers than export controls. Indeed, export controls can often be the legal version of shooting oneself in the foot.

If the President does not want to have his choice of sanctions skewed by the laws, he can declare a national emergency. This gives him sweeping powers over exports, imports, and private credit. But the purpose of the statute that gives the President these powers--the International Emergency Economic Powers Act (IEPPA)--was to reduce resorting to sometimes dubious "national emergencies." Moreover, the criteria for invoking

IEPPA are vague, the Presidential powers are sweeping, and Congress has very little to say. We should not be comfortable with casual resort to it.

Nor should we be comfortable with the crazy quilt of laws for economic sanctions in the absence of a national emergency. For a number of reasons, the United States is increasingly relying on economic sanctions as one tool to further its national security and foreign policy.

Present U.S. Laws

A brief review of the present U.S. laws for exports, imports, and private credit will highlight the gaps and the need for reform.

A. Exports

First, exports. The 1985 Export Administration Act Amendments, among other things, imposed some new limits on the powers of the President to impose export controls. As this Committee will recall, the new limits include: a 60-day limit on grain embargoes for foreign policy purposes unless Congress passes a joint resolution; tougher criteria for imposing foreign policy controls; and an expansion of protection for "contract sanctity."

Nevertheless, with few exceptions (generally in the agricultural area), the President today still has sweeping powers to cut off almost all U.S. export trade, or any segment of it. There would usually be no effective Congressional, administrative, or judicial review of his decisions.

B. Imports

Unlike exports, the President's authority to limit imports for national security or foreign policy reasons is very limited.

There are numerous laws that might be used for one reason or another to limit imports. However, almost all of them are triggered not by national security or foreign policy reasons, but by economic considerations, such as discriminatory pricing and subsidies.

A few laws give the President some discretion in the national security or foreign policy area, but all these laws are limited in their scope.

Probably broadest is Section 232 of the Trade Expansion Act of 1962 which permits the President to "adjust the imports" of an article if it "is being imported into the United States in such quantities or under such circumstances as to threaten to impair the national security ...." This provision is not only limited to "national security" concerns, but also its legislative history and actual practice suggest that it is essentially for protecting the U.S. production base for critical defense materials. President Reagan's 1982 embargo on oil imports from Libya has been the only use of Section 232 for primarily foreign policy reasons.

Beyond that, the President's authority over imports are limited to very specific areas. The 1985 foreign assistance act, for example, gave the President the authority to cut off imports from Libya. The President also has some discretion over sugar and beef quotas. In addition, there is the ban against the importation of seven Soviet furs. It's known in the field as the prohibition on the seven deadly skins.

C. Exports of Capital, or Private Credit

Just as the President's power over imports is very limited, his control over exports of private capital, or of private credit, is even more limited. The conventional wisdom is that banks are heavily regulated. In fact, this regulation is essentially concerned with banks' liquidity and solvency, and not with whether their activities are consistent with U.S. foreign policy.

If Chase Manhattan Bank wants to loan to Poland, or Iraq, or Chile, the President has very little statutory power, in a non-emergency situation, to prevent that loan for national security or foreign policy reasons.

The President's primary statutory authority over private capital is Section 15 of the Export Administration Act covering export financing. Section 15's language and legislative history suggest that it is only designed to help implement export controls. Hence, it authorizes restrictions on the financing of exports subject to controls, as well as other financial restrictions designed to thwart violations of the export controls. Section 15 does not seem to be an independent authority to control international payments or other financial transactions.

What about informal pressures by the President on the banks? While banks are extensively regulated, commentators differ on just how effective a President could be in informally asking banks to restrict their financial transactions with a particular country. One recent, excellent study by a banker suggests that such pressure would often be unsuccessful, given the long history of U.S. banks maintaining an arm's length relationship with the U.S. Government on foreign policy matters. In any case, it seems somewhat strange for this country to depend on the very uncertain tool of informal persuasion, given the variety of circumstances and possible time pressures when the United States might want to impose financial controls on a large number of transactions by many private entities.

Incidentally, the limited influence of the President over private banks is unlike the situation in some other countries. While I am not an expert on this, there appears to be considerable cooperation in West Germany between the banks and that Government, and even more extensive cooperation in Japan.

Our review of the present U.S. laws suggests the need for a better legal system for imposing economic sanctions in non-emergency situations. For a number of reasons, Presidents will want to continue to impose these sanctions. We should make the system less haphazard. Without casually resorting to his sweeping national emergency powers, the President should be able to choose the sanctions most likely to be effective and in the U.S. interest. He should be able to choose from the broad range of options, rather than simply selecting those sanctions, such as export controls, that he has the legal authority to employ today.

I believe that the President's authority to impose economic sanctions for national security and foreign policy reasons should be expanded, in a careful fashion, over both imports and private credit.

S. 812

That brings us to S. 812. As noted earlier, I support the general thrust of S. 812--to give the President more authority to impose controls over capital exports, or private credit. However, I have three major concerns about the bill.

First, why should the bill be limited to restrictions on capital to "controlled," or Communist, countries?

Economic sanctions have been, and will be, imposed for a variety of national security and foreign policy reasons against a number of countries--communist and non-communist. The President should just as much have a full menu of options for use against countries supporting terrorists or abusing human rights, as for Communist countries.

Indeed, capital controls are likely to provide maximum potential leverage where U.S. banks, traders, and other entities have traditionally extended much credit--both in absolute terms and relative to the amount provided by non-U.S. entities. The larger the U.S. amount, the more likely a prohibition or restriction on new credit would squeeze the target country.

Traditionally, U.S. entities have not provided much credit to the Soviet Union or Eastern Europe. For example, U.S. banks now apparently hold only 5% or less of the total debt owed by the Soviet Union and other Comecon countries to foreign banks.

In contrast, U.S. banks, traders, and other entities have provided large amounts of credit to a number of non-Communist countries in Latin America and Asia which conceivably could be a target of U.S. foreign policy controls at some time in the future. These include, for example, Chile and South Korea. Of total foreign bank claims against these countries, U.S. banks at the end of 1984 provided about 51% of the loans to Chile and 31% to South Korea.

Let me suggest that the President should have authority to control most exports of capital, just as he has for most exports of goods and technology. That brings me, however, to my second question.

Second, should not the President's power over capital be used only in cases where important U.S. national security or foreign policy interests are involved?

S. 812 does not hedge the President's authority to control capital with the same relatively detailed restrictions now required for export controls on goods or technology for national security or foreign policy reasons.

As you well know, many in Congress and elsewhere have been troubled with some uses of export controls in the past. This accounts for some of the 1985 Export Administration Act amendments--such as on the duration of agricultural embargoes, the criteria for imposing foreign policy controls, and the expansion of contract sanctity.

I believe that any use of credit controls should be restricted at least as much as controls over the export of goods or technology. For example, I would hope that the President would have to think seriously before imposing credit controls that hindered sales of U.S. grain to the Soviet Union or Eastern Europe, and might even be prohibited from imposing credit controls solely for that end.

Indeed, because the threat of capital controls might tend to scare away foreign borrowers, traders, or depositors, I recommend that the Committee consider restricting the potential use of credit controls even further. While I earlier questioned S. 812's limitation of controls to Communist countries only, maybe the capital controls should only be used if some other controls were imposed. For example, to ensure that the President only resorts to capital controls in a serious dispute, the bill might require some "linkage"--that is, he could not impose these controls unless he also imposes controls on exports, or on imports, or on some government programs, such as foreign assistance or airplane landing rights.

Third, should there not be further study of the possible effectiveness of various types of controls on capital and further study of possible enforcement problems?

Money is very fungible. Millions of dollars can be transferred among several banks by wire in a few moments. Money can not be traced as easily as, say, a large Digital Corporation computer.

Serious research and analysis of the possible effectiveness and enforcement problems of various types of credit controls are surprisingly sparse. The potential for effective sanctions and for adequate enforcement seems to vary by the financial transaction being covered.

For trade financing through letters of credit and specific loans, credit controls can probably be effective and reasonably enforceable. The traders usually use a bank in either the importer's or exporter's country and there is plenty of documentation.

However, banks often make large loans unrelated to a particular trade. For instance, U.S. banks might loan $500 million to Poland or Chile to help on balance-of-payments problems. If the United States prohibited such a loan, how effective would this be? Instead of the prohibited loan, a U.S. bank might in good faith make an inter-bank loan to a German or Swiss bank. The next day that foreign bank might make the loan to Poland or Chile, at a slightly higher interest rate.

As for foreign deposits in the United States, the Iranian case demonstrated that such deposits could, with some difficulties, be frozen. However, will giving the President the power to do this in a non-emergency situation scare away many foreigners who would otherwise deposit their funds in U.S. banks? Should we exclude from the bill the power to freeze foreign deposits in non-emergency situations?

Again, in spite of my questions, I commend Senators Garn and Proxmire for beginning the legislative effort to provide the President with some authority to impose controls on the export of capital in non-emergency situations. As my comments suggest, however, some difficult research and analysis is still needed to make this the best bill possible.

Thank you.

Biography

Barry E. Carter is currently an associate professor of law at Georgetown University Law Center and co-director of Georgetown's joint degree program in law and international studies. He teaches a variety of international courses, including International Business and Economic Law.

He has an extensive background in foreign policy and national security affairs. He served as Senior Foreign Policy Advisor on the Mondale/Ferraro staff in 1984 and was a senior counsel on the Senate Select Committee on Intelligence Activities in 1975. He was a Fellow at Harvard's Kennedy School of Government and an International Affairs Fellow at the Council on Foreign Relations in 1972. A member of Dr. Kissinger's National Security Council staff from 1970-72, he worked especially on the Strategic Arms Limitation Talks and on other U.S.-Soviet and NATO issues. While an Army officer, he was a program analyst in the Office of the Secretary of Defense in 1969-70. He has also practiced law in San Francisco and Washington, D.C.

Mr. Carter, a native Californian, graduated Phi Beta Kappa from Stanford University in 1964, received a master's degree in economics and public policy from Princeton's Woodrow Wilson School of Public and International Affairs in 1966, and graduated in 1969 from Yale Law School, where he was the Projects Editor of the *Yale Law Journal*.

His present professional activities include membership on the UNA's Soviet-American Parallel Studies Project, which has annual meetings with Soviet foreign policy experts. He is also the Vice President of the Arms Control Association and a member of the Council on Foreign Relations. Mr. Carter has published a number of articles on national security and legal issues.

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

January 22, 1986

Dear Mr. Chairman:

As you requested, I am enclosing written responses to additional questions for incorporation in the record of hearings on S. 812.

SENATOR GARN QUESTIONS FOR MR. MULFORD

1. In your written testimony you state that the provisions of the bill would authorize controls on financial transfers to the Peoples Republic of China. The bill, you will recall, authorizes controls on transfers to the section 5(b) controlled countries. I was under the impression that China was removed from the controlled country list on November 23, 1983, and placed on the country list V (under the Export Administration Regulations), and described as friendly non-aligned. Country Group V includes countries such as France, the United Kingdom, West Germany, as well as Egypt, Israel, and Yugoslavia. Is this just an oversight in your testimony, or is there some way in which you see the provisions applying to China if the bill were law today?

ANSWER: The People's Republic of China remains a "controlled country" for purposes of section 5 of the Export Administration Act. Section 5 of the Act provides in part that "[i]n under this section, the President shall establish as a list of controlled countries those countries set forth in section 620(f) of the Foreign Assistance Act of 1961. . . ." The current list of countries under section 620(f) includes the People's Republic of China.

SENATOR MATTINGLY QUESTIONS FOR MR. MULFORD

1. If capital controls are good for dealing with South Africa, why shouldn't the President have the option with regard to the Soviet Union or Vietnam?

ANSWER: He does. The authority provided to the President under the International Emergency Economic Powers Act (IEEPA), which was used as the basis for the controls on South Africa, is available for use with respect to other countries. Vietnam is already subject to controls under IEEPA's predecessor, the Trading With The Enemy Act.

If the President didn't need to wait for allied support in the case of controls against South Africa, why must it be a precondition for dealing with the Soviet Union?

ANSWER: Allied support is not a precondition for imposing controls under IEEPA.

2. The President declared a national emergency in order to control bank loans to the South African Government. Would you describe for the Committee the nature of the "unusual and extraordinary threat...to the national security...of the United States" that justified the use of the President's emergency authority?

The International Emergency Economic Powers Act (IEEPA) was enacted in order to limit the President's use of these sweeping emergency powers to truly emergency situations, in order to avoid the frequent declaration of national emergencies. Aren't emergencies like the one we are currently in, by Presidential proclamation, dangerously stretching the meaning of national emergency?

Does Congress need to tighten up the definition of national emergency even further?

ANSWER: In his message to Congress of September 9, 1985, the President set forth the reasons supporting the declaration of a national emergency in response to the actions and policies of the Government of South Africa, which he found to constitute an unusual and extraordinary threat to the foreign policy and economy of the United States. The President stated in his message that:

> It is the foreign policy of the United States to seek peaceful change in South Africa, and in particular an end to the repugnant practice and policy of apartheid and the establishment of a government based on the consent of the governed. Recent developments in South Africa have serious implications for the prospects for peaceful change and the stability of the region as a whole, a region of strategic importance to the United States. The recent declaration of a national emergency in 36 magisterial districts by the Government of South Africa, the mass arrests and detentions, and the ensuing financial crisis are of direct concern to the foreign policy and economy of the United States.

The President has explained to Congress the reasons for declaring national emergencies with respect to other countries such as Nicaragua and Libya. The Treasury Department does not believe that these declarations stretch the meaning of the term national emergency ("an unusual and extraordinary threat to the national security, foreign policy, or economy of the United States") found in the IEEPA. We do not see any need for Congress to tighten up this definition any further.

3. Without this legislation what do you estimate will be the exposure of U.S. banks in the eastern bloc two years from now?

ANSWER: I do not want to predict what U.S. banks' exposure will be in the future in the absence of legislation such as S. 812, because there are many factors that may change. U.S. banks may change their evaluation of the creditworthiness of individual borrowers or find that the demand for funds by Eastern Bloc nations has declined or increased.

4. Of funds or credit obtained from western financial institutions what percentage do you estimate are used to obtain western technology or goods that have a military application in the USSR? What suggestions do you have for making sure that this country's export control efforts are not compromised by the availability of credit for eastern bloc nations?

ANSWER: In my testimony I mentioned that it is not impossible that hard currency lent to these countries for general trade puposes might be used for military uses or acquisition of technology because money is fungible and you cannot ensure that every penny lent will end up used as intended. However, it is not possible to calculate such use.

We cannot control the availability of credit to the Eastern Bloc, as I explained in my testimony, but we can enforce our existing export controls effectively to reduce the flow of technology and strategic exports to the Eastern Bloc. The optimal approach is to tighten enforcement of rules of the Coordinating Committee for Multilateral Export Controls.

Sincerely,

David C. Mulford

David C. Mulford
Assistant Secretary
International Affairs

The CHAIRMAN. Dr. Pipes.

STATEMENT OF DR. RICHARD PIPES, HARVARD UNIVERSITY

Dr. PIPES. Thank you, Senator.

I am not an economist or a banker, or a lawyer, and such advice as I can furnish on the problems raised by this bill are political in nature. That is proper when you deal with the Soviet Union or any Communist country because in all societies, but particularly in Communist societies, there exists a close connection between economics and politics.

SOVIETS VIEW EVERYTHING IDEOLOGICALLY

The entire experience of the Soviet Union indicates that its leaders view everything, including economic matters, from a political point of view. Therefore, to separate politics from economics, as our allies in Europe tend to do, to say, "Yes, we will stand up to them politically and even militarily, but we want to trade with them and extend credit to them" and so on, makes little sense.

Every economic relationship with the Soviet Union or another Communist country has political ramifications—whether in a positive or in a negative sense. The money loaned so generously to East

European countries in the 1970's had a profound effect on what happened to these countries.

Similarly, when Russia or the Polish Government under Russian prodding in December 1981 cracked down on Solidarity—I was at the time working in the National Security Council—we found that the only steps we could take to protest against this outrage were of an economic nature.

The Soviet Union has been supported economically and financially by the West almost from the very beginning. There is a mistaken notion that in the 1920's and 1930's the Soviet Union pursued an antarctic economic policy. In fact, the first 5-year plans were heavily supported technically and in other ways by the West.

Almost all Soviet oil refineries, for example, built in the 1930's were built by Americans; so, too, were the biggest Soviet car factory, steel plants, and so on and so forth, which were built by American engineers using American designs.

This dependence on Western technology and Western credits has increased in the past 30 years.

The Soviet Union needs Western credits and so do its dependencies. First of all, they buy technology, as has been mentioned. This becomes ever more urgent as the commodities which they export—and they are a Third World country in this respect—decline both in quantity and in price.

The Soviet Union has used petroleum as its main hard currency earner and as has been mentioned, its productivity declined along with the price—the same thing applies to gold, to diamonds, and to other raw materials. Consequently they have an ever greater need for credits.

U.S.S.R. SUBSIDIZES ITS SATELLITES

They also need to subsidize their colonies in Eastern Europe and elsewhere. It is well known, that the Soviet Union spends a great deal of money in subsidizing—directly or indirectly—Eastern Europe, Cuba, Vietnam.

Some of the money is in the form of lower prices on commodities sold, but some of it is in the form of direct hard cash currencies.

A Rand study conducted last year estimated that the Empire costs the Soviet Union over $40 billion a year in subsidies and handouts.

So they need money for that. And because of these two considerations, that is the need to buy technology and the need to use money to support foreign ventures and control their foreign dependencies, the Soviet Union attaches a great deal of importance to Western credits.

There is also a third dimension, and that is a psychological one. The Soviet Government, as its predecessor, the Tsarist Government, attaches great importance to being able to obtain credits abroad at relatively low rates.

The Tsarist Government enjoyed an excellent credit rating in Europe before the revolution and used it to attract an immense amount of foreign capital. It used that ability to bolster its prestige internally; so does the Soviet Government.

I understand from a banker I have talked to that on some occasions the Soviet Union will obtain fictitiously low rates of interest for a project in order to bolster its prestige and then compensate for the loss by paying above-market prices for the product purchased with the money.

That shows how important it is to them from the political point of view, from the prestige point of view, to gain access to Western credits. This is quite apart from the other considerations which I have mentioned.

It seems to me for these reasons that the Senate bill is a very good thing, particularly since it gives the President discretionary powers, and does not compel him to act.

There are two arguments which can be raised against this proposal. One is that it may be perceived by the Soviet Union as an unfriendly gesture and thereby undermine some of the steps that we have taken to improve relations with it in the past 1½ years.

I do not think that is a terribly valid argument. The Soviet Government has a thick skin. It has put up with all sorts of measures of this kind from us, from other countries such as China, and if it is in its interest, it will pursue good relations. If it is not, then you need no cause for them not to do so.

The other argument, and it is the more telling one, is that unilateral controls on flow of capital will be totally ineffective because other countries will step in and fill the gap. Now, that is true as far as the conclusion goes, but I think the remedy should be not for us to join the allies in extending credits to the Soviet bloc but rather to persuade our allies to join us in withholding them.

It seems to me the greatest weakness of our alliance system is that it concentrates exclusively on the contingency of an all-out war which is quite unlikely, and ignores the reality of neither war nor peace with which we have to live.

I think it is imperative that we extend the alliance with NATO and with Japan to include, in addition to technology which we really ineffectively control, also to credits.

For all these reasons, I support this bill and I hope that one can persuade the administration to view it similarly.

[Paper by Dr. Richard Pipes follows:]

SURVIVAL IS NOT ENOUGH

Soviet Realities and America's Future

Richard Pipes

SIMON AND SCHUSTER
NEW YORK

would lead to a disintegration of the Alliance and the loss of the Continent. Mr. Michel Tatu, a prominent French journalist, has argued this point very convincingly:

> Every government and every society seeks security not in order to become part of one or another system and thus as an end in itself, but because security will permit the government or the society to maintain its identity and its values. Just as a shipwrecked person who has lost one plank will not let himself drown but will look for another plank, so there is no reason to suppose that the European governments, not abandoned by America but simply invited to take charge progressively of their own defense, will immediately give up the values in whose name they [have] so long attached themselves to America. . . .
>
> Must one believe that the European attachment to liberalism and democracy is valid only so long as the United States is willing to guarantee these values? Or is it rather the contrary, that the alliance with America springs from the Europeans' own attachment to these values? The argument that Europe would turn herself into another Finland lacks dignity as well as cogency.[28]

Should Western Europe confront the prospect of Finlandization or still worse, it is certain to galvanize its resources; but this can happen only if and when the United States extricates itself from the psychological dependence on the Alliance, which allows many Europeans to pretend they are doing the United States a favor in allowing themselves to be defended.

5 THE ECONOMIC ASPECT

In the West it is widely believed that the Soviet economy is self-sufficient and that, for Moscow, commercial relations with it are an option that it is at liberty to exercise or to reject. This assumption makes it possible to argue that there is no point in resorting to sanctions and embargoes to withhold from Communist states equipment and technology; the only effect such measures have is to push the Soviet Union toward autarky, to deprive Western firms of business, and to worsen the climate of international relations.

For all its popularity, this argument rests on a fallacious premise. Solid evidence that no one so far has been able to refute shows that the Soviet economy has never been self-sufficient and today is less so than ever. From 1921 onward, almost without interruption, the USSR has been importing from the West significant quantities of materiel and know-how to modernize existing industries and to introduce new technology. In the words of Antony Sutton, the author of the most comprehensive survey on the subject, "from 1930 to 1945 Soviet technology was in effect Western technology converted to the metric system."[29] The debt of the Soviet Union to Western assistance is not widely known, because neither of the parties involved wishes to advertise it—the Soviet Union wants to avoid the embarrassment of conceding that it is more or less permanently dependent on the "capitalist camp," while Western firms are coy about doing business with a power that most Westerners view as hostile and spend great sums to arm themselves against. (To this day, the U.S. Department of Commerce will not release lists of industrial corporations granted export licenses to the Soviet Union, although such business is perfectly legitimate.)

Western assistance to the Soviet economy began as early as 1921, with the inauguration of Lenin's New Economic Policy. At that time, the not inconsiderable industrial plant that the Bolsheviks had inherited from the tsarist regime lay in shambles; Russian industry, for all practical purposes, had ceased to function. The first foreigners invited to help with industrial reconstruction came from Germany, with which Moscow had signed a trade agreement that year. Their assistance helped Soviet industry to attain by 1927 prewar production levels. In the late 1920s, the USSR switched most of its business to the United States, whose corporations became a major factor in the implementation of the first Five-Year Plan. At this time, Ford Motors constructed in Soviet Russia a huge integrated plant at Gorkii to build Model A cars, trucks and buses. General Electric helped with the development of Soviet electrical industry, while DuPont contributed to the chemical and RCA to the communications industry. Mr. Sutton estimates that during this critical phase of Soviet industrial development, at least 95 percent of Soviet industries benefited from Western assistance.

This cooperation continued during the 1930s. The McKee Corporation of Cleveland designed the famous Magnitogorsk steel mill, a copy of U. S. Steel's plant at Gary, Indiana, then the largest integrated iron and steel plant in the world. All the refineries in Russia's principal oil-producing area at Baku were constructed by United States firms, which also furnished them with the bulk of their drilling and pumping equipment. Most of the plants built during the third Five Year Plan (1936–40), with the exception of those working exclusively for the military, were planned and in many cases constructed by Western companies, including (for a while) even those from Nazi Germany. Later on, during the war, U.S. Lend Lease provided the USSR not only with expendable military materiel but also with advanced equipment, which is estimated to have increased Soviet industrial potential by one third.

The point is that Western involvement was at no point marginal and therefore a matter of choice; it was all along essential to the entire Soviet industrialization drive. "During the period from 1930 to 1945, Soviet technology was almost completely a transfer from Western countries . . ." Mr. Sutton concludes, "No major technology or major plant under construction between 1930 and 1945 has been identified as a purely Soviet effort."[30]

So much for the vaunted Soviet self-sufficiency under Stalin. In the decade that immediately followed World War II, the USSR imported little from the West, because it needed time to absorb its Lend Lease equipment and the immense quantities of war booty that it had seized in Germany and Eastern Europe. The purchase of Western equipment and know-how resumed in the late 1950s, this time on a grander scale than ever before. The critical factor which made such an expansion of industrial imports possible, was a change in the attitude of Western governments; whereas before they had been rather neutral toward trade with Moscow, they now began actively to encourage it. It is difficult to tell whether in this case economic interest was the driving force and the expectation of political benefits a rationalization, or the other way around; the consequences were the same. Since the late 1950s, Western governments have cooperated with their banks and business corporations to promote exports of industrial equipment and technology to the USSR and Eastern Europe, as well as to enhance the latter's ability to earn hard currency with which to pay for these goods. Since the USSR is relatively poor in cash and usually suffers an unfavorable balance of trade with the industrial countries, no significant expansion of East-West trade could take place without Western credits, and no credits would flow without government participation. The latter assumes two forms: Western governments lend directly to Communist countries to enable them to pay for purchases from their business firms, or else they guarantee repayment of the loans extended to the exporting firms by private banks. By availing themselves of this credit, Warsaw Pact countries have run up a debt of over $80 billion, most of it in the decade of the 1970s. The USSR likes to insist on paying for its loans interest rates that are substantially below (as much as 5 percent) those prevailing on international markets. The purpose of this practice, with which Western governments and banks connive, is to help the Soviet Union maintain the reputation for unique creditworthiness and, in this manner, to enhance its international prestige. As a rule, the USSR discreetly compensates its creditors for their losses on interest by paying premiums for the goods and services purchased with the borrowed money. An interesting variant in East-West trade practices are the so-called "compensation" deals under which the USSR repays its loans not in cash but in the product that the loans had made possible. This method has been employed in financing the Siberian pipeline, the costs of which are to be recovered in future deliveries of natural gas.* For a while the Soviet leadership believed that it had found in "compensation" arrangements a kind of financial perpetual-motion machine: Western firms would develop Soviet industrial capacities and natural resources at little or no cost to Moscow, receive payment in the product, reinvest the proceeds, and so on, in perpetuity. Unfortunately, it soon dawned on their European partners that by so doing they were competing against themselves and as a result compensation deals became much less popular than expected.

Western economic involvement in the Soviet Union and Eastern Europe since the 1960s has been deep and consequential. Once again, as happened in the 1890s and 1930s, the USSR has received from the West essential help modernizing those industries that advances in technology had rendered obsolete and familiarizing it with technologies that it has not been able to master on its own.

A survey of the technology acquired by the USSR in the past quarter century from the West shows the following:

□ Motor vehicles: Italy has built for the Soviet Union at Togliatti a giant automobile plant (equipped mainly, it may be noted, with United States machinery) to turn out copies of Fiat passenger cars, while Pullman-Swindell of Pittsburgh, a subsidiary of the M. W. Kellogg Co., has constructed for Moscow on the Kama River the world's largest truck plant. The two establishments account for the production of one half of Soviet passenger cars and heavy trucks, respectively.

□ Oil industry: the equipment purchased by the USSR from the West has enabled it to raise substantially its oil production, by some estimates as much as two million barrels a day, which at 1984 prices brings in (or saves) $21 billion a year: in effect, this imported technology subsidizes Soviet energy exports to Eastern Europe.

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* After these costs have been repaid, the income generated by gas sales is expected to be used by Moscow to buy imports from Germany and the other countries in Western Europe. It was obviously the desire to place cash in Soviet hands for such purchases rather than the alleged need to diversify energy supplies that motivated the German government, financial institutions and corporations to promote the Siberian pipeline with such single-minded determination, even at the risk of conflict with the United States.

□ Chemical industry: the USSR has carried out an ambitious program of importing chemical plants from the West. These have largely freed it from the necessity of buying chemicals abroad.

□ Electronic industry: the Soviet Union has made abroad significant purchases of integrated-circuit technology.

□ Steel: Moscow has purchased abroad the equipment to produce high-grade specialized steel; currently, the French company Creusot-Loire is constructing in the USSR a mill capable of turning out seven million tons of such steel annually.

□ Ammonia: Western equipment has enabled the USSR to become the world's leading exporter of industrial ammonia.

□ Natural gas: the story of the Yamal Pipeline, built with the assistance of critical Western technology (large-diameter pipes and compressors) and capital is well known. At present, negotiations are quietly underway to continue such development beyond the existing line. In addition, the German company Mannesmann is negotiating for contracts to build in the Soviet Union synthetic liquid fuel plants estimated to be worth as much as $16.5 billion.

□ The bulk of the Soviet merchant navy—the largest in the world—consists of vessels built by foreign shipyards.

Unusual reticence accompanies these and other industrial endeavors, as if the parties had entered into a gentleman's agreement to keep the information privileged.

The industrial assistance given to the Soviet Union helps its military effort directly and indirectly—directly, by providing so-called "dual use" technology which can be used for the production of both military and nonmilitary equipment; and indirectly, by strengthening the Soviet wartime mobilization base. The development of Soviet energy resources has the effect of providing the USSR with hard currency which its own economy cannot generate; normally, most of it is spent on acquiring abroad equipment of some military application.

The so-called "dual-use" technology, lavishly sold to the USSR in the 1960s and especially 1970s, has had a most impressive effect in enhancing Soviet military power. While basic Soviet military equipment is of native manufacture, the West and Japan have supplied Soviet war industry with specialized and advanced technology which Soviet engineers integrate into their output—it makes all the difference between equipment of adequate and superior quality. A plant built by a United States corporation to manufacture rock-drill bits to explore for oil can be and very likely is used to turn out antitank ammunition. Specialized steel sold to the USSR has a variety of applications in tank armor and submarine hulls. Integrated circuits, knowledge of which was acquired in the West, have critical applications in electronic warfare. And it takes no great imagination to realize that the heavy trucks that the Kama River truck plant turns out are either shipped to the Red Army or earmarked for it in the event of hostilities. The same applies to the merchant marine, which in peacetime catches fish and transports cargoes, but forms an integral part of the Soviet Navy and operates under its command.

The most shocking instance of the contribution that Western technology has made to Soviet military capabilities was the sale by the United States in the early 1970s of equipment to manufacture miniature ball bearings. As noted above (p. 98) the Soviet leadership decided in 1959–60 to proceed with the mass-production of nuclear weapons. German technology, acquired after World War II, combined with native science and industry, provided nearly all the components required. Among the equipment that could not be produced domestically, however, was machinery to manufacture large quantities of miniature ball bearings for missile-guidance systems. At the time Soviet representatives approached the only firm that made such machinery, the Bryant Chucking Grinder Company, of Springfield, Vermont. In 1961, with Soviet orders pending, Bryant applied for a license to sell this equipment to the Soviet Union, but Defense Department objections moved President Kennedy to deny the application. In 1972, in the more favorable climate of détente, Bryant applied once again for a license to ship to the USSR its Centalign grinders. This time, permission came through.[31] The bearings produced by this United States equipment are almost certainly integrated into the guidance system of Soviet missiles. In the opinion of some experts, they have materially contributed to the enhancement of accuracies of Soviet missiles, to the extent of putting at risk the United States force of Minuteman ICBMs and requiring the development of a new land-based missile, the MX.

NATO long ago recognized the need to withhold from the USSR, and from countries likely to pass on to the USSR, equipment with indisputable and direct military applications. In practice, enforcement of this principle has been hopelessly lax, especially since the inauguration of détente. The agency charged with monitoring technology transfer to the East is known by the acronym COCOM. Formed by NATO countries in 1949 with headquarters in Paris, and joined a few years later by Japan, COCOM maintains lists of embargoed technology, agreed upon by the Allies. Alas, COCOM is virtually powerless to carry out its mandate. It is assigned an absurdly small budget (under $500,000 a year) with a correspondingly minuscule staff and can only recommend but not enforce its recommendations. In practice, it routinely processes and approves requests for the sale of equipment and technology to the Soviet Bloc; and on the infrequent occasions when it turns down a request, it has no means of ensuring that its decisions are implemented, because it has neither the necessary authority nor the personnel. After President Nixon assumed office, the United States relaxed significantly its more stringent national rules on exports to Communist countries, which in turn caused a further watering down of COCOM. If one adds that the neutral countries of Europe—Switzerland, Sweden and Austria—do not even receive COCOM recommendations and both sell embargoed materiel and provide transit for it, it becomes evident that few effective restrictions exist on the transfer to the Communist Bloc of advanced technology with direct military application. The West, notably the Federal Republic of Germany, France and Japan, which together account for nearly two thirds of the technology sold to the USSR (1979) constitutes a giant supermarket of military know-how where the USSR shops (often with borrowed money) for goods to integrate into its arsenal of destruction. The United States alone seems to be aware of the danger of such sales and makes an earnest effort to control them. But Washington has difficulty maintaining its resolve in the face of unremitting pressure from both the Allies and domestic commercial interests, usually backed by the Departments of State and Commerce, which argue that such restrictions serve only to divert Soviet business elsewhere. In his first eighteen months in office, President Reagan had tried to enforce industrial controls, but his resolve weakened as the Allies refused to cooperate and United States business firms loudly complained. By the end of 1983, he seemed to have given up trying. The sad reality is that while there are powerful vested interests lobbying for exports, no one has a vested interest in restricting the flow of technology to the potential enemy. Private enterprise does not seem especially concerned who buys its product, as if oblivious of any connection between technology and military power; and governments lack the will to impose on it considerations higher than immediate profit. So it happens that while the West busily arms itself, it also helps arm its opponent.

The transfer of military technology, however, is not the only problem; another major Western contribution to the Soviet military effort lies in assistance extended to its mobilization base. As pointed out above (Chapter Three), in the Soviet Union the line separating the military and civilian economies is so indistinct as to be almost meaningless, inasmuch as the leadership views the entire national economy as either actually or potentially destined for military ends: we are dealing here with a war economy operating on a moderate level of mobilization. It has been noted that Soviet military personnel participate closely in economic planning and carry a strong, probably decisive voice in decisions on allocations for the civilian sector of the economy. The central planning agency, Gosplan, makes no major investments unless the generals on its staff are satisfied that they meet the needs of wartime mobilization. Furthermore, each major industrial establishment has a military office that supervises those departments that work for the armed forces. On the eve of World War II, the German High Command compiled a list of Soviet war industries: this list turned out to have been virtually identical with a list of Soviet industrial establishments.[32] Nothing suggests that matters have changed in this respect. Since the Soviet leadership views all industries in the light of their contribution to the war effort, it must view industrial imports in the same manner; from which it follows that *any* contribution to the Soviet industrial potential is at the same time a contribution to its war-making potential. Help extended to the Soviet Union to construct plants for the manufacture of goods which ostensibly serve peaceful purposes, such as automobiles and trucks, tractors, or specialized steel, serve in fact a double purpose, partly civilian, partly military, with the military one always paramount.

The other objection to technology and equipment transfer has to do with its effect on the Stalinist system. Foreign technology and foreign credits help prop up an economic regime which shows every sign of having lost its vitality; they also enable Moscow to allocate its capital and resources in a manner that continues to favor the military sector. It is in the interest of the West that the USSR reform its labor policies, raising productivity by greater incentives and decentralized decision making. This would represent a step toward weakening the economic and political power of the *nomenklatura*. To the extent that it helps to make the system more efficient, Western technology makes it easier to avoid such reforms. If one can imagine a Soviet economy that would be one hundred percent automated and able to dispense with human labor altogether, such an economy would be entirely freed from the need to take the human factor into account: it would make people redundant altogether. Of course, such an economy is not possible; but everything that contributes to the automation of Soviet production, that supplies it with what the Stalinist system cannot provide, serves to solidify the despotic arrangement.

Were it not for vested interests, that is, for individuals and firms profiting from such business, it would not be difficult to make an unanswerable argument against sales to the Soviet Union and its dependencies of any equipment or technology with likely military applications. The matter turns more contentious, however, as soon as one comes to materiel that has no obvious military application, the development of Soviet natural resources, and the extension of credits. In this sphere, one runs also into convictions about the value of international trade as a bridge among nations and a force for peace.

Commerce among nations is indubitably an instrument capable of bringing them closer together because it weaves a tissue of private bonds independent of and more durable than the volatile political relations that link sovereign states. It has been almost axiomatic in Western thought since the early eighteenth century that everyone profits from trade to the extent that one is able to buy abroad commodities more cheaply than it costs to produce them at home; it has an additional bonus in that it brings nations into peaceful intercourse. Indeed, international relations may be friendly or they may be hostile, but international trade can only be friendly. It is difficult even to conceive what "hostile trade relations" could be; the concept seems a contradiction in terms. (Tariff wars, embargoes and the like can be set aside for the purposes of this discussion since they are forms not of trade but of political interference with it.) It has been the consensus of Western liberal literature for over two centuries that trade spells peace, and restrictions on trade mean war. Roosevelt's Secretary of State, Cordell Hull, was merely restating a commonplace when he wrote of himself:

> toward 1916 I embraced the philosophy I carried throughout my twelve years as Secretary of State. . . . From then on, to me, unhampered trade dovetailed with peace; high tariffs, trade barriers, and unfair economic competition, with war. Though realizing that many other factors were involved, I reasoned that, if we could get a freer flow of trade—freer in the sense of fewer discriminations and obstruction—so that one country would not be deadly jealous of another and the living standards of all countries might rise, thereby eliminating the economic dissatisfaction that breeds war, we might have a reasonable chance for lasting peace.[23]

Economic benefits may accrue under any arrangement of international trade; but the political benefits expected of it are in fact confined to commerce between private parties. Trade between governments is indistinguishable from state-to-state relations, being subordinated to them and just as volatile; the same rule applies when one party is private and the other public.

Now, trade with the Soviet Union and the other Communist countries falls entirely into the last-named category. Western private firms negotiate contracts with appropriate Communist ministries (usually in close cooperation with their own governments), without ever coming into contact with the population at large; the process brings together corporate officials of the one party with public officials of the other. The population remains uninvolved and largely uninformed. It is possible that if the inhabitants of the Soviet Union knew that the bulk of their automobiles are produced with "capitalist" machinery or that much of their meat comes from livestock raised on imported fodder, they would develop friendly attitudes toward the foreign supplier. But most of them do not know this; the facts are deliberately concealed from them and hence cannot serve as blocks for building "bridges" between West and East.

A further argument made in favor of East-West trade as a political instrument holds that as the East expands its trade relations with the West it becomes dependent on it and therefore is constrained from engaging in "adventures." This was the celebrated doctrine of the "web of interest," which argued that the ties created by commerce would gradually bind the USSR to its political rival in other ways as well. To the extent that détente had a theory, it rested on the notion, formulated by Mr. Kissinger, that the transfer to the East of credits, machinery and food would in time translate into political gains. The implausibility of this occurring should have been evident to anyone with a modicum of historical recall. In the 1920s and 1930s, when the USSR relied heavily on Western know-how and equipment to industrialize, it pursued a rigidly Stalinist course at home and abroad. Even after World War II, when its economy lay in ruins, Moscow refused the proffered Marshall Plan aid, and ordered its clients to follow suit, because it objected to the political strings that it believed attached to it. If Marxism means anything, it means the dependence of politics on economics, a principle of which not even the most obtuse member of the *nomenklatura* can be unaware. It is therefore not in the least surprising that the expectations of the 1970s were cruelly disappointed. Upon entering into the détente relationship Moscow took extreme care that the economic assistance which it solicited not place it in conditions of dependence or constrain its freedom of movement. Its preference for buying samples of equipment to copy, and for so-called "turnkey factories," which, once made operational by foreign specialists, passed fully under Soviet management, are manifestations of this awareness.

Characteristically, even Communist Poland, which, following a less cautious policy, had made itself heavily dependent on Western suppliers and bankers, did not allow economic considerations to affect its conduct once the decision had been taken to crush Solidarity. Notwithstanding Western threats of embargoes and credit denials, it proceeded methodically to dismantle the free institutions that endangered its authority. This nonchalance must have been influenced at least in part by the knowledge that European governments and banks, which had lent it some $25 billion, had a high stake in raising Poland's productivity, since exports were the only way it could obtain the hard currency with which to honor its debts. Economic generosity has thus not yielded political leverage; the "web of interest" proved to be spun of gossamer. A chastened Henry Kissinger conceded that much a decade later, when he described as "fallacious" the theory of the "automatic mellowing effect of trade":

> Soviet behavior in recent years has given the lie to the argument that trade and credits by themselves will bring about a benign evolution of the Soviet system. Soviet-Cuban intervention in Angola, in Ethiopia, and in South Yemen; the invasion of Afghanistan; the suppression of Solidarity in Poland; and the use of toxic chemical and biological warfare in Afghanistan and Southeast Asia have all occurred in precisely the period of expanded East-West economic cooperation.[34]

Speaking realistically, the only justification for East-West trade for Western firms is to make money, and for Communist countries to acquire advanced technology. Every other excuse involves either self-deception or hypocrisy. The alleged "fall-out" from trade in the form of good will and political leverage has proved to be too elusive to deserve serious consideration.

"Money answereth all things," says the author of Ecclesiastes, but the question is: Does it make sense for society to let itself be heavily taxed to pay for its defenses and, at the same time, for private enterprise to make profit by helping the potential enemy improve his military capabilities? Do the few millions earned by this or that corporation—as often as not one that has lost its economic viability anyway and can be kept alive only by subsidized exports to the East—justify the much larger sums that have to be spent by taxpayers to match the improvements in the Soviet arsenal that these profits make possible? These questions answer themselves.

To stop the flow of technology to the Soviet Union it is necessary to resort to a variety of constraints on trade, and in this connection the question arises: How effective are such constraints? The response depends on the circumstances in which they are applied as well as on one's definition of "effectiveness." A recent survey of nearly one hundred sanctions applied in the course of the twentieth century indicates that in a surprising number of cases—more than two out of five—they have indeed "worked" in the sense that they have contributed to making the countries to which they had been applied comply with the stated political demands of the country that had put them into effect. However, success was obtained mainly in cases involving a large power against a small one. Where two great powers were involved, the results were much less clearcut.[35]

As a rule, a great power invokes sanctions against another great power in response to actions that it sees as a gross violation of accepted norms of international behavior or as an immediate threat to its security. Because of this cause-and-effect relationship —outrage followed by sanction—the public views punitive measures as intended to compel the other party to recant. If they do not do so, sanctions are judged a failure. For instance, in 1935, in response to Mussolini's invasion of Ethiopia, the League of Nations voted sanctions against Italy. Italy, however, not only refused to withdraw its troops but carried the campaign to a successful conclusion and then annexed Ethiopia. In 1979, Soviet armies invaded Afghanistan: this time the United States took the initiative in imposing against the aggressor sanctions, which some Allies ignored and others half-heartedly imitated. Five years later, the Soviet Army was still ravaging Afghanistan, whereas the sanctions were being quietly lifted. Observing such experiences, one may well conclude that it is useless for one great power to impose sanctions on another, because no power of the first rank will tolerate having its actions controlled by another power.

The matter acquires a different complexion when one separates the event that has led to sanctions from the purpose of the sanctions—that is, when one ceases to insist that as long as event X had been the reason for the punitive measures, then the aim of these measures must be nothing short of reversion to the state of things before X had taken place—Italy out of Ethiopia, Russia out of Afghanistan. It is doubtful whether any statesman in invoking sanctions had ever expected such a result. This is not the purpose of international punitive measures. Their purpose is to communicate to one's own public and to the aggressor the sense of outrage; it is a demonstration of great value quite independently of its immediate and practical results.

One only has to consider what happens when aggression is not followed by some kind of punitive measures: not to react in such instances is silently to condone them. Because in 1968 the Soviet invasion of Czechoslovakia had not been followed by sanctions, Moscow was free to attribute to the West the view that Eastern Europe was its preserve where it could behave as it pleased. This consideration may have contributed to the Soviet decision in 1979 to invade Afghanistan, for, although Afghanistan was not in Eastern Europe, it had been for many years tacitly acknowledged to lie in the Soviet sphere of influence. This time sanctions were imposed. The Soviet Union did not react by withdrawing from Afghanistan, nor was it expected to do so. But the strong response from the United States in 1979 may well have influenced the Soviet Union not to send its troops into Poland a year later. We do not know this for certain and will not know until the archives of the Politbureau have been opened for inspection. But it is not unreasonable to assume that the penalties, more or less openly discussed by NATO in the event of Warsaw Pact's armed aggression against Poland (they included the likelihood of a cancellation of the Siberian pipeline) weighed heavily on the scales when the decision fell in favor of internal repression. The relative mildness of martial law in Poland and the efforts of the Polish government to give the appearance of moderation are almost certainly related to its desire to have the United States lift its sanctions, which it admits to having cost it many billions of dollars.

If economic sanctions were eliminated as an instrument of foreign policy, then the West would be left with no responses to aggression other than military action or acquiescence. Since military action against the USSR is in practice out of the question, failure to resort to sanctions is inevitably interpreted by Moscow and the public at large as acquiescence. Thus, the effectiveness of sanctions must be measured by another yardstick than the customary one—their purpose is not so much to compel the aggressor to repent and recant as to give expression to moral indignation, to send a message, and to raise the costs of aggression. It is a political measure, first and foremost, the effectiveness of which can only be judged when set against the costs of inaction.

Curiously, opponents of sanctions against the Communist Bloc have no difficulty understanding their utility when the intended object is South Africa or some other "right-wing" regime. In such cases, *The New York Times* and liberal legislators loudly demand sanctions, while academics call for their universities to "divest" themselves of stocks in companies doing business in South Africa as a way of expressing outrage with apartheid. *The New York Times* thinks it also a fine idea to prevent Colonel Qaddafi from buying technology in the United States as punishment for invading Chad —this, it says, will cause the aggressor "frustration" and "show him our contempt."[36] For some reason, however, where the Soviet Union or some other Communist country, such as Poland, is concerned, moral considerations recede, and sanctions are declared "empty" gestures.

In the case of the Soviet Union, a coordinated Allied policy of economic denial would have the most profound effects on both the nature of the Soviet system and its military capabilities.

Nothing that the West could do—certainly no arms-control agreements—would contribute more to restraining Soviet military capabilities than a well-formulated and strictly enforced interallied embargo on both military and "dual-use" equipment and technology. As we have pointed out, materiel imported from the West since the late 1920s has greatly contributed to modernizing Soviet industry and thereby also the Soviet military, which enjoys with Soviet industry a symbiotic relationship—he who feeds the one fattens the other. A COCOM that would work from comprehensive lists of embargoed goods, that would have the authority and the personnel to enforce its recommendations, would make an immense contribution to Western security. If a fraction of the emotion invested in arms-control agreements went into keeping technology out of Soviet hands, the world would be a much safer place.

But beyond withholding equipment and know-how, the West should also refrain from making it possible for the *nomenklatura* effortlessly to earn foreign currency. The development, with Western capital and equipment of Soviet export industries, notably energy, enables Moscow to keep intact its lopsided priorities, which are heavily tilted in favor of military expenditures. The contribution that Western aid in these fields makes to the preservation of the *status quo* in the USSR seems more evident to some Soviet commentators than to the Western proponents of détente. Thus, the authors of an article in *Pravda* on the Siberian pipeline explained to their readers that the moneys earned abroad from this undertaking made it possible for the country to preserve its patterns of investments: "The construction of the . . . pipeline using commercial credits on a compensatory basis frees us of the necessity of diverting budgetary resources from other economic programs."[37] What these other "economic programs" are the authors did not spell out, but they obviously include military ones.

Another step which could usefully be taken would involve abolishing state guarantees of loans and credits extended to the Communist Bloc, which would force firms and banks to assume all the risks and treat business with the East as a strictly commercial proposition.

The purpose of the West in its commercial dealings with the Communist Bloc should be twofold: first, to keep out of its hands anything able to contribute directly or indirectly, now or in the event of war, to its military potential; and, second, to enable internal pressures generated by the failures of the Stalinist economy to build up to the point where they compel a diversion of resources from military production and give further impetus to economic reform.

6 WHO SHOULD BE IN CHARGE OF POLICY TOWARD THE USSR?

The Department of State is widely thought of as the proper agency to conduct the foreign policy of the United States; an arrogation of this responsibility by another agency of the government is seen as a violation of both the constitutional division of powers and of good political practices. This view is incorrect on two counts. The constitution, in effect, charges the President with the conduct of foreign affairs, so no matter how much authority the President may decide to delegate to his Secretary of State, the ultimate responsibility is his. This means that the State Department cannot be the prime mover of foreign policy: constitutionally it is the agency that implements the President's will.

This holds true also for reasons of practical politics. The belief that the State Department is the proper instrument of foreign policy derives from the fallacious view that foreign policy is synonymous with diplomacy—which, as has been pointed out, is not the case. The Department of State is the branch of government specifically responsible for diplomacy in all its aspects, and this involves, first and foremost, the peaceful resolution of disagreements and conflicts with other sovereign states. This task has a great deal in common with law. And indeed, on closer acquaintance, the Department gives the impression of a giant law firm. Its staff of Foreign Service officers, many of them highly competent in the area of their responsibility, are professionally trained to reach agreements—a successful diplomat is by definition one who knows how to negotiate an agreement favorable to his country. Diplomats have an instinctive aversion to violence and an insurmountable suspicion of ideology; the one is to them evidence of

The **CHAIRMAN**. Thank you, Dr. Pipes.

Mr. Schechter, this is a vote. Senator Proxmire has already left to vote. So we will take a short recess and I will play O.J. Simpson through the halls and get back as rapidly as I can.

[Recess.]

The **CHAIRMAN**. The committee will come to order. Gentlemen, thank you for waiting.

Mr. Schechter, please proceed.

STATEMENT OF HENRY SCHECHTER, DEPUTY DIRECTOR, ECONOMIC RESEARCH, DEPARTMENT, AFL-CIO

Mr. **SCHECHTER**. Mr. Chairman, I appreciate the opportunity to present before you the views of the AFL-CIO on S. 812.

AFL-CIO STANCE ON FINANCIAL ASSISTANCE TO COMMUNIST NATIONS

The AFL-CIO has long been a forceful advocate of the view that financial assistance should not be extended to Communist and other countries that violate human rights, including the suppression of free, independent trade unions.

A few years ago, when Poland was about to default, we were all for letting them default and suffer the economic consequences, which would have been a cutoff of credit, I believe.

In a narrower vein, S. 812 would authorize actions to be taken in the context of existing trade and credit relationships to prevent the transfer of sensitive goods and technology to the Soviet Union and its allies.

In that context, my statement today addresses questions as to the workability of potential effectiveness of S. 812 to achieve its desired objective from the national security viewpoint.

I think from what I have heard here today, unanimously there has been the opinion that it would be ineffective to have this unilateral approach. I have traced in my statement the various ways it would become ineffective—the transfer of funds, funds that cannot be traced, credit whether from the United States or from other countries where the Soviet Union could get credits for more than it needs to pay for a particular thing. Again, the fungibility of money idea.

The fact that the Soviet allies have had a favorable balance of trade with the United States, a few of them, and therefore they have obtained hard currency.

The fact that U.S. travel abroad and expenditures abroad provide dollars around the world and there are, of course, the Eurodollar market floating around—I do not know whether it is $1 to $2 trillion—which makes hard currency available through various channels.

You have the numbered accounts in a few countries where money cannot be traced. There are various ways of getting around it, around what would be an attempt for a specific unilateral capital flow control.

I do think that general controls over capital flow would be perhaps be useful at various times for the purpose sought by this bill, as well as at times economic stabilization and other purposes.

For example, certainly there was great effort though including international organizations to help the Latin American countries repay their debts—and they had capital outflow controls, each one of them. But we did not, and the rest of the economic community around the world did not have laws or have really attempted to stop the intake of capital which was illegally exported or illegally taken out of those individual countries.

We had the cases of the unreported transactions in cash of $10,000 or more which many of our banks handled earlier this year. It was sort of ironic that here were banks who were looking for repayment of large foreign credits they had extended from countries which were exporting dope, and many of those laundered funds they were accepting probably were from those countries.

NEED OF A UNIVERSAL AGREEMENT

So again illustrating the fact, you have to have pretty well a universal agreement, at least among the capitalist countries, to handle the capital flows.

I would question whether the President could not today, as far as negotiations go—he has Ambassadors. I believe they are allowed to discuss such prospective things if they wish to. But for all the reasons I have indicated and on which there seems to be general agreement, the ineffectiveness of the S. 812 technique, as much as we would like to see something done, we would not want to support it and would want to help in looking for a more promising solution to the problem.

[The complete prepared statement follows:]

85-52

STATEMENT OF HENRY B. SCHECHTER, DEPUTY DIRECTOR OF ECONOMIC RESEARCH, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS BEFORE THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE, U. S. SENATE ON S.812, TO AUTHORIZE THE PRESIDENT TO RESTRICT THE EXPORT OR TRANSFER OF MONEY OR OTHER FINANCIAL ASSETS TO COUNTRIES SUBJECT TO NATIONAL SECURITY EXPORT CONTROLS

December 4, 1985

I appreciate the opportunity to present before you the views of the AFL-CIO on S.812, the proposed Financial Export Control Act. The AFL-CIO has long been a forceful advocate of the view that financial assistance should not be extended to communist and other countries that violate human rights, including the suppression of free, independent trade unions. A few years ago when Poland was about to default on loans to the U.S. government and banks in this country, we advocated that Poland should be allowed to go bankrupt and suffer the economic consequences.

In a narrower vein, S.812 would authorize actions to be taken in the context of existing trade and credit relationships, to prevent the transfer of sensitive goods and technology to the Soviet Union and its allies, since such transfers contribute to a relative weakening of the security interests of the United States. In that context, my statement today addresses questions as to the workability and potential effectiveness of S.812 to achieve its desired objective from a national security viewpoint.

S.812 would provide authority for efforts to close a financial loophole in the Export Administration Act that enables the communist countries to obtain the latest U.S. materials and technology. Although such exports to designated countries are controllable under the Export Administration Act, the communist countries can buy materials and advanced technological equipment from smugglers or paid agents in a third country who have made such purchases in the United States. Whether it is a legal or illegal transaction, the intermediaries who obtain the materials and sell and have them delivered to the Soviet Union or its allies will demand cash for both the materials and their services. As has been pointed out by the Chairman of this Committee, not only will the intermediary traders demand cash but they will generally demand it in U.S. dollars from the country receiving the goods. To prevent such activities, it is proposed under S.812, that the Export Administration Act of 1979 be amended to restrict the export of capital, the extension of credit, the making of loans or the transfer of financial resources to "controlled countries" to which the export of sensitive goods and technology is restricted under the Export Administration Act of 1979.

In essence, the President would be authorized to prohibit or curtail, or in some way regulate, the transfer of financial assets to any country or party acting on behalf of the government of a country to whom the shipment of strategic materials or equipment has been proscribed. The Secretaries of State, Defense and Commerce or heads of other appropriate agencies would be responsible for conducting negotiations with other countries regarding their cooperation as to controls that would be imposed by the President.

Thus, S.812 would authorize a form of selective capital controls, applicable only to certain designated countries, and requiring the cooperation of other countries.

Unfortunately, such selective capital flow controls pose serious questions of acceptability from a U.S. economy viewpoint and of effectiveness in achieving the desired objective. To start with, the U.S. deals with the U.S.S.R. and a number of its close allies and also trades with Mainland China to the tune of billions of dollars each year. In 1984, the U.S. exported to the U.S.S.R. about $3.3 billion worth of merchandise and imported from the U.S.S.R., $600 million of merchandise, so that we enjoyed a favorable balance of trade of almost $2.7 billion with the Russians. In past years, in connection with U.S. merchandise sales to the Russians some credit extension has been involved. Wherever they purchase their imports in the future, the Russians probably could obtain more credit than they really need to supplement their cash available for payment and conserve accumulated hard currency to pay for purchases of proscribed U.S. materials and technology through third country intermediaries. Since money is fungible, credit that supposedly is obtained for other purposes, can provide the cash for proscribed U.S. exports through a third country.

1984 U.S. TRADE WITH COMMUNIST COUNTRIES
(Millions of Dollars)

Country	U.S. Exports	U.S. Imports	U.S. Trade Balance
German Democratic Republic	136.9	167.2	- 30.3
Czechoslovakia	58.3	95.9	- 37.6
Hungary	88.2	241.8	-153.6
Poland	318.3	244.4	73.9
U.S.S.R.	3,283.9	600.1	2,683.8
Albania	9.3	2.6	6.7
Romania	248.6	969.0	-720.4
Bulgaria	44.1	31.0	13.1
Subtotal	4,187.6	2,352.0	1,835.6
Vietnam	22.2	0.1	22.1
China (Mainland)	3,004.3	3,381.2	-376.9
Mongolia	0.1	2.4	- 2.3
Subtotal	3,026.6	3,383.7	-357.1
TOTAL	**7,214.2**	**5,735.7**	**1,478.5**

Source: U.S. Department of Commerce, Bureau of the Census; FT990/December 1984

In all probability, since the Russians are able to raise billions of dollars from domestic and external sources to pay for their imports, they could raise some additional tens of millions of dollars to pay intermediaries that would operate through trans-shipments from non-communist countries to provide some of the materials and equipment whose export to Russia and its allies might be prohibited under the Export Administration Act.

If the availability of dollar currency is a problem for the Russians, they can also overcome it because several of their allies in Europe enjoy a positive balance of trade with the U.S. Thus, in 1984, Romania had a $720 million favorable trade balance with the United States. Romania is an oil exporter, and international oil transactions are settled in dollars, so it probably garners dollars from other sources, as well as from the United States. Hungary, Czechoslovakia, and East Germany also enjoyed positive balances of merchandise trade with the U.S. in 1984, in amounts ranging between $30 and $150 million. While Mainland China is not on the friendliest terms with Russia at this time, it is worth noting that in 1984, they also had a $377 million favorable merchandise trade balance with the United States. It would seem, therefore, that a sizeable amount of dollar currency could be picked up by communist countries in the course of trade with the United States.

In addition to trade, it might be noted that in 1984, U.S. citizens spent $21.3 billion in foreign travel and also expended $2.9 billion for purchases while abroad. Probably a measurable proportion of such travel and purchase expenditures accrued as income to communist country enterprises.

Then there are havens in the world, some of them well established, where people can maintain numbered deposit accounts, and the laws of the land prohibit the ownership of the deposits accounts or details of deposit and withdrawals to be revealed. Depositors having such accounts can pick up the telephone and order a transfer of funds to a financial institution in another country, and the funds will most likely be in a hard currency. Somebody with such an account, including U.S. citizens, can readily have funds transferred to parties in different parts of the world. The funds can then be used for payments for purchases of materials and equipment with no available evidence as to where the money came from before it went into that account, or where it went when it left that account.

Another fact that must be considered is that currency is readily transportable. It may be relevant to recall a recent news story about shipments of certain types of steel into the U.S. from countries that do not have steel plants, but also have no quota restrictions against such shipments into the U.S. Apparently, the quota-restricted types of steel were shipped from producing countries that had reached the limit of an established U.S. import quota to non-producing countries that had no quota limit, and the latter simply trans-shipped the material. The same sort of operation has been used in connection with textiles and apparel to circumvent quota agreements with the country of origin of the shipments. Trans-shipments of money are harder to detect and follow than steel or textiles.

The capability to transfer funds from one country to another despite prohibitive laws has been well illustrated. Many of the Latin American countries in recent years have sought to conserve foreign exchange in order to repay foreign debts, and have tried to enforce a general capital outflow prohibition, particulary to conserve dollars. Nevertheless, as related in a Fortune magazine article by a financial analyst using data from a Federal Reserve study, while the Latin American countries were borrowing heavily and trying to conserve dollars, many residents converted their local currency into dollars and invested them in foreign assets. He calculated that from 1973 to 1984, residents of four countries, Argentina, Mexico, Brazil, and Venezuela acquired about $1 billion in foreign assets. In the U.S., earlier this year, there was a spate of reports about a number of sizeable U.S. banks that had failed to make required reports to the Treasury Department of transactions involving more than $10,000 in cash. Some of the deposits were in millions of dollars and originated overseas. It was thought likely that many of these transactions involved laundering of money obtained in prohibited activites.

General controls over capital flows could perhaps be useful at various times for law enforcement, economic stabilization and other purposes. However, it would require an international orgranization of non-communist countries, including those who extend and those who are potential recipients of international credit, who would agree in advance on the reasons for implementation, and forms of controls that would be enforced by all of the countries.

Given the difficulty of trying to enforce more general capital flows, and the much greater difficulty of trying to prohibit capital flows of funds to be used for specialized purposes in a relatively few designated countries, the proposed selective capital flows controls to be authorized by S.812 probably could not be successfully enforced to achieve the desired objective. Reported experience in trying to obtain information about transactions from numbered accounts in connection with U.S. tax cases, is one indication of great difficulty in obtaining cooperation from other countries as to the movement of funds. A somewhat different indication relating to the proscribed movement of goods, goes back to the period when the U.S. attempted to exercise export control with respect to equipment that was needed by the Russians to build the Siberian gas pipeline. The export of pipelaying machines of American manufacturers were prohibited both from the U.S. and from European countries where the manufacturers were subsidiaries of American companies. The Japanese supplied the pipelaying machines. At a later stage when various power operated motors, pumps, and other such equipment was needed, some of our European allies supplied such equipment.

Based on recorded experience, in assessing the chances for success of the provisions of S.812 for a very selective capital flow control, requiring cooperation from governments that encourage numbered accounts, and from allies whose producers are anxious to sell products in question, we conclude that there would be many more failures than successes. Perhaps more important than a waste of costly effort, would be to depend on the use of techniques to solve a problem which cannot be solved with such techniques.

Therefore, while wholly sympathetic to the aim of S.812, the AFL-CIO does not endorse the proposed legislation because it would not be effective. It would be an illusion to enact S.812 and believe that it had provided a solution to a significant problem. A more promising solution to the problem has to be found.

PRESENT INERTIA OF GOVERNMENT

The CHAIRMAN. Mr. Schechter, we would appreciate it if you do have any specific recommendations. I cannot disagree with what most people have said—Dr. Pipes agreed too, it is the most telling argument against it.

I hate to surrender, though, just because we are told that it does not work. I hear that so much in Government. In my lifetime, there have been a number of things that I was told that I could not do, would not work, but I kept trying.

I did not get to fly in space because everybody told me I would never get there. Believe me, I was told that for a long period of time. That is why I made the comment to the administration earlier, it is the same old testimony.

They change the faces; they change the Secretaries; people change, administrations change. But they do not come up with a new argument or any recommended solutions. That is what I am groping for. I never have any great pride of authorship in a bill, S. 812 does not excite me. I do not go home and think about it at night.

I am looking for some means and some realistic suggestions from people on, how to solve our problem. Everybody agrees the problem is there. As long as we continue to surrender and say it will not work we won't get anywhere. So we continue saying we cannot do it and our allies are not nice and so on——

Mr. SCHECHTER. Mr. Carter also suggested a multilateral approach on capital flows, I believe, and Dr. Pipes did too.

In a way, we have an institution that we are a part of, an international institution, and there was some legislation adopted in 1983 which placed a greater onus on that institution where we have a great deal of influence, to adhere to certain things.

I am talking about the IMF. In the 1983 amendments to that legislation, the Bretton Woods Agreement Act, section 43 was added, dealing with Communist dictatorships that place severe constraints on labor and capital, and so on.

We then put in the legislation instructions to the Secretary of the Treasury to instruct the U.S. Director of the IMF to oppose certain types of loans if certain conditions were not met. And when we oppose certain types of loans in the IMF, I believe they cannot be made, or certain programs, as they are called, cannot be adopted, because we have a veto vote there.

Now, the IMF is an organization that deals with the banks all the time. As a matter of fact, I have often wondered why they did not ask, at times, when debtor countries that were under IMF programs and had capital outflow restrictions in order to garner their exchange to be able to pay their debt more readily, if the banks, let us say, in the United States had used their good offices to guard against inflows of such illegally extracted funds from those countries. It would be helpful to the banks themselves.

So I think there is an avenue here to be explored, an avenue which would make for a multilateral approach. I think, as I said, that would be useful in many other respects.

I agree with what Professor Pipes said about the connection between the political and the economic policies in various countries. I think this holds not only in the Soviet Union, I think it holds in a place like Chile where Pinochet keeps strong economic controls and this ties in with his ability to maintain dictatorship—they support each other.

So I think it would behoove us to explore the IMF route.

The CHAIRMAN. Well, I agree with you. The problem that I see, we put in provisions like that, instructing our voting members and all of that. I am one who usually puts those provisions in. You know what they do? They ignore us. They do not go ahead with those instructions. Even if they do it comes back, "Well, we only have one vote, it does not really mean anything anyway."

EXAMPLE OF KENNECOTT SHUTDOWN

I do not know how to get people to move on the problem. Let me give you a specific example that gets away directly from credit controls, but it gets to the issue of something that is very important in my State. Kennecott Copper Corp. used to be the biggest private employer in the State. It used to be the biggest open pit copper mine in the country, in the world.

It was the largest taxpayer, private taxpayer, property taxpayer in Salt Lake County. It is totally closed down—for a lot of reasons, among them too strict environmental controls. But the major reason was unfair foreign competition, the world price of copper.

You talk about the IMF and the World Bank, here to help Third World countries. We subsidize loans, credits, and so on, to build copper-producing facilities. Then, when they start producing and they have subsidies from their own governments, they lower the price of copper to keep employment in their country.

Then, when they suffer a loss, the compensatory financing facility, the IMF, comes in and compensates for them. Now, you ought to try to be a Senator from Utah, gentlemen, and explain why my copper workers are all unemployed and we have U.S. taxpayers' dollars as part of our quota to the IMF and the compensatory financing facility helping them build those facilities, so they can then undercut the world price of copper and then be compensated for their losses while we are losing all of that in my State and in other copper-producing States around the country.

Now, I not only cannot explain that, I do not understand it. So I try to get the administration—Senator Domenici and I—to talk.

Well, you go to Chile and Zambia, and some of these other countries. You try and impress on them just in informal, bilateral talks, that it might be in their best interest to cut the production of copper. The world price would go up a few cents and they would possibly even do better financially with less production at a higher cost. The administration refuses to even carry on those talks—not trying to mandate to do anything.

So you say this is an avenue to explore. I agree. But I have explored so many avenues and I do not even have hair to pad my head as I butt against the deadend alleys that I continue to run into.

Dr. PIPES. If I may volunteer an opinion on the subject "it will not work": it has been my experience that when people say, "It will not work," they usually do not want it to work.

This is, for example, very noticeable in the field of strategic defenses. The scientists, who say that SDI is not feasible technically are the same scientists who, if you press them and ask, "Suppose it is feasible, is it desirable?" will say,"No, it is not desirable."

So they begin by saying, "We do not want it," and then conclude, "It will not work."

It is similarly so in the field in which we are dealing here today. There is a very large constituency in the executive branch—the Departments of Commerce, Treasury, State—which believes that economic sanctions of any kind are counterproductive. These people believe that we must, of course, arm ourselves; we must have a tough defense posture; we must protest Soviet violations of human rights, aggression and so on.

BELIEF THAT ECONOMIC INTERCOURSE IS A GOOD THING

But they also believe—and this is particularly true of Europe—that economic intercourse is a good thing. That it, that brings the Soviet Union into the community of nations.

They then produce the argument that sanctions do not work, as you have mentioned, Senator. Economic sanctions somehow seem to work when they want them to work, as in the case of South Africa. Then, suddenly and miraculously, they became very effective. But in regard to the Soviet bloc they are said to be ineffective.

The reason is that these people really do not want sanctions: indeed, they know that they just might prove all too effective. Now, you could also make an argument that one must not have any controls on exports of technology because we have no monopoly on any branch of technology. Therefore, if we do not sell it, the Russians will get it somewhere else. And yet, we have managed to establish CoCom which—imperfect though it is—does in some way control the flow of technology from the allies. We are not selling advanced computers to them.

The CHAIRMAN. CoCom would work better if we were not the No. 1 requester of exemptions.

Dr. PIPES. Even so, we do have CoCom. We have agreed that we can seek to limit the flow of technology. Similarly with credits: we could have an equivalent of CoCom in the field of credits for the Soviet bloc within which the allies would consult, ask each other if this is a desirable thing in the present conditions from the political as well as economic points of view.

But before we can ever get to that, we have to overcome the bias in favor of trade as an alleged agent of peace, which is as widespread as it is wrong, in my opinion.

The CHAIRMAN. Gentlemen, let me again request of all of you, not just in the formality of a hearing today, if you come up with specific recommendations that you think would be helpful, either in amendments to the bill, suggestions for modification and changes or other avenues that might be productive in this area, I would appreciate it if you would communicate that to the committee.

Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Dr. Pipes, the National Bank of Washington in its June 8, 1985 publication, International Views, stated:

> There are reasons to believe that six Eastern European countries will be tempted again to borrow from the hard currency areas. One reason is that the Soviet Union has demanded that they provide it with their highest-quality machinery and industrial consumer goods, as well as food—precisely those items they, meaning the Eastern European countries, would want to sell to the West for badly needed convertible currencies.

Do you not think that if that analysis is correct, that it would increase political tensions between the Soviet Union and its Eastern bloc allies if our banks did not step in and provide the hard currencies needed by these Eastern European countries? Would that not be in our national interest? Would it not help weaken the ability of the Eastern European countries to supply high quality machinery—directly or indirectly—to the Soviet Union—which has a direct or indirect benefit to their military capability?

SOVIET POLICY IS CONTRADICTORY

Dr. **Pipes**. I think so. I agree with that. The Soviet policy in regard to Eastern European countries is very contradictory.

Senator **Proxmire**. Is what?

Dr. **Pipes**. Is very contradictory. On the one hand, Moscow wants them to increase the sale of high-quality manufactured goods to the Soviet Union. But for this to be possible, these countries have to sell more to the West where they obtain advanced technology.

Poland, for example, during the great buildup of its industries in the 1970's, has become heavily dependent on Western spare parts and so on. To be able to buy those spare parts, Poland should be able to export to the West.

The Russians want the West to export primarily to the Soviet Union and, at the same time, to increase the quality and quantity of manufactured goods, which is contradictory.

The only way that particular gap can be filled and the contradiction overcome, is by means of Western credits. I do not doubt at all that Eastern Europe—Eastern Germany, of course, is a very special case because it gets loans from West Germany—Poland and to a lesser extent Czechoslovakia and the other countries of Eastern Europe will be turning to the West for credits in order to satisfy Soviet demands.

Senator **Proxmire**. Mr. Carter, in February 1982, Felix Rohatyn, senior partner of Lazard Freres, said in testifying before this committee on the Polish debt crisis:

> If the West refuses to provide further credits to Eastern Europe, the Soviet Union will have to do so. This will put great additional economic pressure on the Soviet Union at a time when its own economy is faltering and the burden of defense spending and overseas commitments must be heavy.

He noted that this could mean the Soviets might have to retrench elsewhere. He went on to say, possibly armaments or by a recognition that accomodation with the West is preferable.

Do you agree or disagree with that analysis?

Mr. **Carter**. I agree that we should impose credit controls on the Soviet Union when we find it in our interest because of the situation there.

If I understand Mr. Rohatyn's comments, it was to impose controls when the Soviet Union needed credit.

Senator **Proxmire**. He concentrated in this statement on credits to Eastern European countries, meaning not the Soviet Union necessarily—alone at least—but Poland and East Germany, Romania, and so forth.

Mr. **Carter**. I think we should do it selectively when we are unhappy with what is happening in, say, Poland. That is the time you lean on them. Other times, we might want to assist Hungary or other countries which are trying to gradually break away from the Soviets. We might give them credit.

Dr. Pipes is more of an expert than me on Eastern Europe. But I think the President needs the authority, as you are proposing, so that when it is in our interest to put the screws on, we can do so. When Mr. Rohatyn was speaking, what was happening in Poland was something we objected to.

Senator **Proxmire**. Now, Mr. Schechter, you are an old friend of the committee and we have always had great admiration and respect for you.

I would especially appreciate what Chairman Garn suggested, particularly with respect to you. You said the AFL–CIO is sympathetic to the purposes of S. 812. That is, it does agree that extensions of credit to the Soviet Union, like trade flows, should be handled as part of our overall strategic relationships with the Soviet Union.

I note, for example, your statement that the AFL–CIO believes financial assistance should not be granted to Communist or other countries that violate human rights. I take it you would not want our banks to have unlimited discretion to make loans to the Soviet Union. You believe, however, that S. 812 may no be an effective vehicle to regulate such loans.

Now, if that is true, would you give us your suggestions for amending S. 812 that would enable the President to have the authority to carry out policy goals that the AFL–CIO shares with us?

Mr. **Schechter**. I will be glad to, Senator. As I suggested, I think there are other vehicles, perhaps, to be explored beside the route that S. 812 would take. I will be glad to submit to the committee what I have in mind.

Senator **Proxmire**. If you would do that, that would be very helpful. You might give us two or three options that you might favor because we all want something that would be effective. I am not at all surprised, I would expect that the AFL–CIO would take a position in sympathy to what we are trying to achieve.

[The following response was submitted for the record by Mr. Schechter:]

American Federation of Labor and Congress of Industrial Organizations

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1985 DEC 16 AM 10 13

December 12, 1985

Honorable Jake Garn
Chairman, Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This is in response to requests by you and Senator Proxmire at the hearing on December 4, 1985, for an alternative to the method proposed in S.812 to block financing of purchases and transfers of advanced technology and sensitive materials from the United States to the Soviet Union and its allies.

In my prepared testimony statement I referred to an alternative approach to achieve the objective of S.812, an objective which the AFL-CIO shares with you. I refer to the following paragraph in my testimony.

> General controls over capital flow could perhaps be useful at various times for law enforcement, economic stabilization and other purposes. However, it would require an international organization of non-communist countries, including those who extend and those who are potential recipients of international credit, who would agree in advance on the reasons for implementation, and forms of control that would be enforced by all of the countries.

At the hearing I called attention to the possibility of establishing a function within the International Monetary Fund (IMF) to exercise capital flows controls that could also be made applicable for the intended purposes that led to the proposal of S.812. It would fit in with some of the purposes that the IMF tries to fulfill under its charter. Thus the IMF negotiates with debtor countries, that have trouble repaying their international debts, for the establishment of economic adjustment programs. A main purpose of such programs is for the debtor countries to accumulate a sufficient surplus of hard currency to be able to repay their debts. In order to accumulate the necessary funds, the governments of such countries establish domestic prohibitions against conversion of the local currencies to hard currencies, and either limit or prohibit the export of dollars and other hard currencies. Nevertheless, such restrictions and prohibitions are circumvented and hard currency funds are deposited by citizens of the debtor countries in banks in the United States and in other countries with hard currencies. It defeats the purpose of IMF adjustment programs, and of the creditor banks who need to be repaid, to have such capital flight from the debtor countries. Referring to a related IMF mission, a high-level IMF staff economist, writing in the current issue of an IMF publication, states: "In many developing countries, controls to limit capital outflows may become necessary for the stability of exchange and interest rates." Thus, it would further the economic stability and adjustment program objectives of the IMF, and help the large banks who are the creditors of debtor countries, if the IMF would establish multilateral capital flows controls.

In connection with the establishment of such capital flows controls, furthermore, the IMF probably could also be persuaded to exercise its power to prevent international capital outflows to finance illegal exports from or imports to other member countries, including trans-shipments through a third country.

The United States is by far the most influential member country of the IMF. It is the only one that really has a veto power over program actions by the IMF. The funding quota share and matching voting strength of the U.S. is 19 percent of the total in the IMF, and an 85 percent vote is required for approval of programs. Although two communist countries, Hungary and Romania, are members of the IMF, their combined voting power is about one percent of the total.

Techniques quite similar to what I am suggesting were actually adopted in U.S. legislation in Public Law 98-181 of November 30, 1983, a supplemental appropriations act for the fiscal year ending September 30, 1984. Section 804 of P.L. 98-181, entitled "Instructions to the U.S. Executive Director "amended the Bretton Woods Agreement Act, by adding Section 43 to the latter Act. Section 43(a) directs the Secretary of the Treasury to "instruct the U.S. Executive Director of the Fund to actively oppose any facility involving use of Fund credit by any communist dictatorship, unless the Secretary of the Treasury certifies and documents in writing upon request and so notifies and appears, if requested, before the Foreign Relations and Banking, Housing and Urban Affairs Committees of the Senate and the Banking, Finance and Urban Affairs Committee of the House of Representatives. at least 21 days in advance of any vote and such drawing . . . " The Section goes on to spell out specific conditions which the Secretary must certify have been met by the communist country that wishes to avail itself of IMF credit. Access to such credit is generally also the "seal of good housekeeping" approval which the private banks require before they will extend credit to a country.

Section 43(b) deals with similar instructions to the U.S. Executive Director of the Fund with regard to sanctions by the Fund against countries that engage in apartheid. If any Administration chooses to ignore these sections of the Law, the Congress can summon the Secretary of the Treasury and admonish him for failure to carry out the Law, and direct him to do so.

Another subsection could be added to Section 43 requesting the Secretary of the Treasury to instruct the U.S. Executive Director for the Fund to oppose the availability of any IMF credit facilities (1) to any country which allows capital inflows from countries that have by law prohibitied such fund outflows, or (2) to any country which allows capital outflows to finances exports to final destinations from countries of origin that have by law prohibited such exports to such final destinations. The addition of this section would in effect, be a recognition that basic to stability in international credit and currency markets is the need for international credit and currency transactions to be carried on within the legal framework of the countries that are the locus of the transactions.

Sincerely,

Henry B. Schechter
Deputy Director of
Economic Research

HBS:ack
opeiu2
afl-cio

cc: Senator William Proxmire

Senator **Proxmire**. Dr. Pipes, Senator Moynihan—I guess he was teaching at Harvard when you were teaching there too.

Dr. **Pipes**. Yes.

VIEWS ON DÉTENTE

Senator **Proxmire**. He is a man we all admire and respect. In testifying before this committee on the Polish debt question in 1982, he said:

> The aim of the policy of détente was to lure the Eastern Europeans and the Soviets themselves into an ever larger network of interlocking trade relations which they would be reluctant to disrupt and thus would induce them to behave in ways more acceptable to the democracies.

He concluded by asking:

> What has happened? Afghanistan teaches one lesson. The question of Solidarity teaches us another. We have found ourselves hostage to the very trade relations we established in order to capture the Communist states.

Do you agree with Senator Moynihan's view on détente? Do you likewise think S. 812 might be a useful tool for the President to have in designing our overall relationship with the Soviet Union?

Dr. **Pipes**. Well, as to the notion which did underpin détente, that increased economic contacts between East and West will bring the Soviet Union into the community of nations and induce it to behave in a more civilized way, the author of that doctrine, Kissinger, has admitted it had failed to work.

I have in my book, survival is not enough, a citation from him from, I think, "The New Republic" where he says we had been wrong, it did not work. So we have it from the horse's mouth that it was a failure.

It did not work for a variety of reasons. One is that the Soviet Union made very sure from the beginning that close commercial ties with the West would not make it dependent on the West. Their favorite form of Western assistance were turnkey operations.

For example, we built for them the Kama River plant, the largest truck plant in the world, which turns out trucks for the Soviet military.

Basically, we built it and then turned it over to them. I imagine our engineers have a look if there are some problems. But fundamentally this project did not create any type of dependence of the Soviet Union on us.

Nor did the Togliatti plant which the Italians built for the Russians, the largest automobile plant in the world, create trade dependence.

Second, they have learned something that Plutarch knew, that if you lend somebody a great deal of money, you become beholden to your debtor and not he on you. Plutarch describes a treasurer of Alexander the Great who made sure always to borrow money for his king from enemies because he knew that as a consequence they would never declare war or take any hostile action against him.

That is, in fact, so. Those European countries that have lent heavily to Eastern Europe—are much more dependent on Eastern Europe than Eastern Europe is dependent on them.

So my answer is that détente has not produced the kind of dependence of the Soviet Union on the capitalist world that it was meant to achieve.

Senator **PROXMIRE**. Are those Plutarch's views that you just expressed?

Dr. **PIPES**. I am sorry.

Senator **PROXMIRE**. Did you say that Plutarch said that you should always borrow money from your enemies?

Dr. **PIPES**. Not Plutarch. Plutarch quoted a treasurer of Alexander the Great called Eumenes who, he said, made it a practice always to borrow from enemies.

Senator **PROXMIRE**. In that case, we should borrow money from the Soviet Union.

Dr. **PIPES**. Yes, you may try. [Laughter.]

The Soviet Union borrows from us which makes sense from its point of view because it does create dependence of the creditor on the debtor.

I am in favor of the bill, because I believe that the Soviet threat to us is not primarily a military threat.

Senator **PROXMIRE**. Could you please repeat that?

Dr. **PIPES**. The Soviet threat to the Western world is not primarily a military threat. That is my belief.

Senator **PROXMIRE**. It is not a military threat.

Dr. **PIPES**. It is not primarily a military threat. It is a political threat in which military power, subversion, terrorism, economic penetration, and dependence are all instruments.

ECONOMIC DEPENDENCE OF WESTERN BANKS

Economic dependence results in the kind of dependence I have just described, where Western banks do not dare to move and indeed sigh in relief when there is a crackdown on Solidarity in December 1981 in the hope that the Russians will restore order in Poland and as a result the Poles will pay their debts to them.

The military power is used by them primarily as a means of terrorizing us and blackmailing us.

Senator **PROXMIRE**. Not because of the appalling nuclear power on both sides?

Dr. PIPES. That is only one reason.

Senator PROXMIRE. Recognizing that any war between the two countries would be suicide?

Dr. PIPES. That is one reason, but it is not the only reason. The other reason which, I think, prevailed even before nuclear weapons had been developed, was the feeling that their power internally rests on the sense of invincibility which they convey to the population and which disarms it.

They tell their people, "Look, everybody fears us, it is pointless for you to try to resist us." Even if they suffer defeat abroad—and they are suffering some now in Afghanistan which is very embarrassing—then they erode their domestic prestige.

But I think the prospect of a Soviet attack on the West is the least of our worries. It is the steady erosion of Western power that is troublesome. And economics play an enormous role in this type of conflict.

Since we cannot really employ military power against them and since we cannot really use political subversion in their camp as they use in ours, the strongest tool we have to exert pressure on the Soviet Union is economic that is, the control of technology and control of credits.

Now, it is true—as has been said time and again—that money is fungible and unilateral action will not work. Therefore, I strongly believe that we should expand unilateral action to become multilateral action, by bringing our allies into this.

They will resist, they will be kicking and screaming. But I think our alliance with Europe and Japan is worth much less than it could be because it is preparing for a contingency which is not very high on the Soviet agenda and not for the real and present threat.

Senator PROXMIRE. Mr. Carter, I just have one more question. Apropos the last point, I think, by Mr. Pipes, what do you think of the claim made by our banks that if we do not make loans to the Soviets and other Eastern European countries, European and Japanese banks will. That seems to be the principal argument against our proposal.

U.S. bankers also claim enactment of S. 812 would result in lost business to our banks without achieving any increase in our national security or other political objectives.

We had the same point made by Secretary Mulford earlier. What do you think of those arguments?

Mr. CARTER. First, it is a problem, just as it is with export controls on goods and technology where we worry about foreign availability.

I think it is a problem, but I agree with Senator Garn that we should not deal with it by saying "Let us do nothing." Rather, we should give the President the authority to go forward, but provide him with some criteria and restrictions, just as you have in the present export law, which require him, for example, to consider foreign availability and to consult with the allies.

IDEA OF A FINANCIAL COCOM

In talking about that, I think Dr. Pipes had a good idea about sitting down with our allies and talking about a financial Cocom of some sort.

I do not think we can work through the IMF or the World Bank. They are international in character. Our voting power there is small and a lot of countries there do not share our interests.

However, we should get together the countries with big banks—Japan is second biggest after us, I believe, then France, England, and Germany. We would need these major allies.

Senator PROXMIRE. Right.

Mr. CARTER. To work out a financial Cocom. We might not be able to do this all the time. However, when there are troubles such as there were in Poland or in Afghanistan, the President could move forward decisively with enough allied support to mean something.

He might want to move forward on other occasions just for the symbolism of it. That is his decision. But I think there are times when he should be able to organize substantial support. We just need a few other major countries, the other big banking countries, to move forward decisively in certain situations.

Senator PROXMIRE. Thank you very much. Thank you, Mr. Chairman.

The CHAIRMAN. I believe it was Lenin that said—paraphrasing—that we would sell them the rope with which they would hang us. I do not even think he anticipated that we would loan them the money to subsidize rates to buy the rope with which to hang us.

Gentlemen, thank you very much. Your testimony has been very helpful.

The committee is adjourned.

[Whereupon, at 11:57 a.m., the committee adjourned, to reconvene subject to the call of the Chair.]

[Response to written questions of Senator Garn and additional material for the record follow:]

SENATOR GARN QUESTIONS FOR DR. PIPES

JW

HARVARD UNIVERSITY
DEPARTMENT OF HISTORY
CAMBRIDGE. MASS. 02138
(617) 495-2556/2545

ROBINSON HALL

February 4, 1986

Senator Jake Garn
United States Senate
Committee of Banking, Housing
and Urban Affairs
Washington, DC 20510

Dear Senator Garn:

I am responding with apologies for the delay to your inquiry of January 6.

Q. 1. **What is the likelihood that the Soviet Union and its allies might politically manipulate U.S. bank exposure to them?**

What is the possibility that by borrowing from Western banks the Soviets are creating pro-Soviet lobby groups in the West?

A. 1. The likelihood of the Soviet Union and its allies politically manipulating U.S. banks as a result of loans seems to me small because U.S. banks have always had relatively small exposure to Communist countries. However, the prospect of being able to lend to Communist countries does tend to make U.S. bankers prone to take "soft positions" vis a vis the Soviet Union and, in particular, to oppose restraints on trade with the Communist Bloc.

Q. 2. If you were employed by a large bank to give advice on political, economic, and social conditions of potential sovereign borrowers, what advice would you give about lending to Eastern European countries? Given near term and long-term prospects, what are the chances of an East German debt crisis? What would be the consequences for our foreign policy of such a crisis?

A. 2. The Soviet government has always made it unmistakably clear that it does not adhere to the "umbrella theory" by virtue of which it is said to bear some kind of moral responsibility for the debts of its clients. It demonstrated its earnestness in this respect in 1981, when it refused to come to the assistance fo Poland. On these grounds I would advise against lending to Eastern Europe. East Germany is a rather special case: should there be an East German debt crisis, Moscow will probably look the other way, confident that West Germany will bail its client out.

Q. 3. If this bill were enacted and the President given this authority, would that enhance the President's ability to negotiate effectively with the Soviets, or would it hinder successful negotiations?

A. 3. As I have stated during my testimony, I believe Bill S.812 would strengthen the President's hand in dealing with the Soviet Union.

Yours sincerely,

Richard Pipes,
Frank B. Baird jr., Professor of History

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

LETTER TO VIN WEBER, U.S. REPRESENTATIVE IN CONGRESS FROM THE STATE OF MINNESOTA

LAKEFIELD, MN, *July 29, 1985.*

Representative VIN WEBER,
Cannon House Office Building,
Washington, DC.

DEAR SIR: Belcw is a photocopy of an article which appeared in the Minneapolis Star and Tribune on July 26, 1985. Could you please explain this to me and to your constituents in this area? Common sense tells you that no way can we give Moscow $600 million, and then your Government FDIC comes along with taxpayer's money to bail out the damned big banks.

Please give us an explanation for this disgraceful move at the earliest possible moment. I will expect to hear from you soon.

[Associated Press]

GARN ASKS BAN ON LOANS TO SOVIETS

WASHINGTON, DC.—Sen. Jake Garn, angry about new U.S. bank loans to the Soviet Union, said Thursday that he is seeking legislation that would give the President the power to ban such credits.

Garn, R-Utah, chairman of the Senate Banking Committee, announced hearings and action in September because First Chicago Bank organized a new $600 million loan to Moscow.

"I want to know how the American bankers are going to explain to U.S. citizens who can't get mortgages or are facing farm foreclosures, while their banks are organizing half-billion-dollar loans to our adversaries," Garn said. "I only wish Americans could get the generous loan terms being offered to the Soviets."

Yours very truly,

CLAYTON SCHROEDER.

American Committee on East-West Accord

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November 26, 1985

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, DC 20510

Dear Senator Garn:

Thank you for your invitation to testify on S.812, to amend the Export Administration Act of 1979 so as to authorize controls on the export of capital to countries against which we maintain national security export controls.

The American Committee on East-West Accord has a long-standing interest in this matter, as evidenced by the activity of our members on the Export Administration Act Amendments of 1985. I direct the East-West Trade Program of the American Committee, and was Co-Editor of our 1983 book entitled Common Sense in US-Soviet Trade.

As that title suggests, our approach seeks through reason and experience to advance the national interest and the national security on all fronts. We believe too narrowly based a perspective can miss the realities and wind up harming the nation. This is surely a result we would all wish to avoid.

I would welcome the opportunity to develop this insight as it applies to the particular proposed legislation, but unfortunately I am obliged to devote full attention at this time to the upcoming meeting of the US-USSR Trade and Economic Council, which I will be attending along with many of our senior members. If I may, I will ask that you allow me to suggest two simple points and that you be kind enough to include this letter in the record of your hearings:

1) It seems ill-advised to greet the Geneva Summit, tentative as it was, with so flat a declaration of distrust.

2) There is at least substantial doubt about the factual premise that the Soviets are building their defense capability on a base of Western technology. Ed Hewett of Brookings Institution is a well-informed specialist on these matters whom you may find it useful to consult.

Again, I regret not being with you in person, and I am grateful for the invitation to comment.

Sincerely,

Margaret Chapman

Margaret Chapman
Director of East-West Trade